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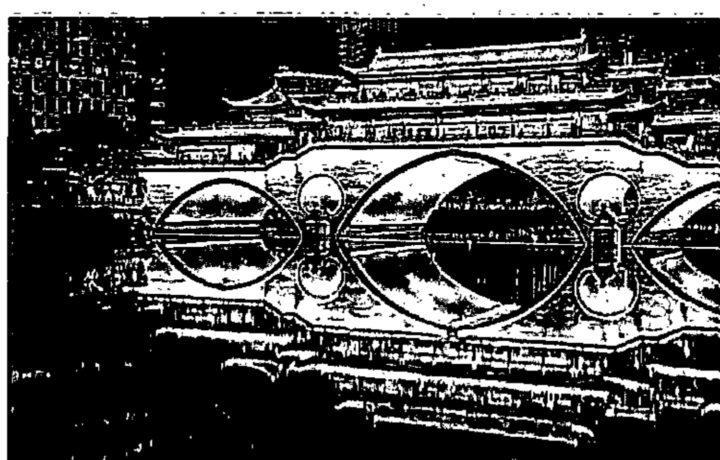
&

Chinese People's Institute of Foreign Affairs

Congressional Staff Delegation to China

August 2018

Briefing Book – Part 2



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MEMORANDUM:

TO: THE STAFF DELEGATION

FROM: MARTIN B. GOLD AND ALLEGRA HAN

RE: ISSUES MATERIAL IN THE BRIEFING BOOK

We attach reading materials on issues we believe may be discussed during your journey to China. They fall into several categories:

1. The general state of bilateral relations

When President Richard Nixon went to China in 1972, he opened the door to the revival of diplomatic ties frozen for more than two decades. In 1949, Chiang Kai-shek and his Nationalist Chinese Government fled the mainland for Taiwan. On October 1 of that year, Mao Zedong stood atop the Gate of Heavenly Peace in the Forbidden City to proclaim the People's Republic of China. The United States refused to recognize the PRC, continuing to support Chiang's claim that his Republic of China in Taipei was the legitimate government of the entire country.

Meanwhile, Mao declared that in the Cold War, China would "lean to one side." At the end of 1949, he traveled to Moscow to seek assistance from Stalin (it was one of only two times Mao ever left China; the other was a second trip to the USSR to celebrate the 40th anniversary of the Bolshevik Revolution). Mao's trip resulted in a 25-year friendship treaty between China and the USSR, and the cementing of relations between the two Communist giants. The strong ties did not last for the duration of the treaty, disintegrating later in the 1950s and through the 1960s.

Tensions between the PRC and the United States quickly took a turn for the worse with the outbreak of the Korean War in 1950. During that conflict, Mao sent substantial numbers of Chinese troops to fight U.S. forces. In so doing, he prevented General MacArthur from securing military dominance over the entire Korean Peninsula and avoided having a hostile government along with U.S. forces on his doorstep. Engagement of Chinese troops in Korea led to a military stalemate and an eventual truce at Panmunjom in 1953.

In turn, the United States doubled down on its relations with Chiang, entering into a Mutual Defense Treaty with the Republic of China in 1954 and steadfastly blocking PRC claims to the China seat in the United Nations.

Several factors caused President Nixon to reconsider America's position.

- He hoped for Chinese help in extricating the United States from Vietnam
- He wanted better relations with China as a way to balance and leverage the Soviet Union

- Communist control of mainland China was evidently stable and beyond the capacity of the Nationalist Chinese to disturb
- In continuing to recognize the ROC as the legitimate government of all China, the United States was ignoring obvious realities and isolating itself from many of its allies who, over time, had recognized the PRC.

For its part, China was interested in ties with the United States to counter the Soviets, who they views as hostile and extremely dangerous. While China did not give Nixon much help on Vietnam, bilateral relations were based on a common Soviet enemy.

Nixon's February 1972 trip followed two exploratory missions by his National Security Advisor, Henry Kissinger, and set in motion a process that led to normalization of diplomatic relations on January 1, 1979.

The Soviet threat to China and to the United States diminished markedly before the collapse of the USSR at the end of 1991. Moreover, with Mao's death in 1976 and Deng Xiaoping's consolidation of power two years later, China began to open itself to the world. Reform and Opening Up replaced Maoist autarchy, and China rose from extreme economic backwardness. American business took notice (as did other Westerners) and commerce with China started to expand. Due to these two fundamental changes, economics replaced security as the leading basis of U.S.-China ties. We are now each other's largest trading partner.

Next year, China and the U.S. will mark 40 years of diplomatic relations. By now, it is the most important bilateral relationship in the world – sometimes rocky, sometimes cooperative, but always important and always evolving.

The Briefing Book contains articles from both American and Chinese authors.

Part I has material pertinent to the state of bilateral relations.

Part II speaks to trade relations. This is a broad topic that embraces five subtopics: the balance of trade; conditions of participation in the Chinese market, including the theft or coerced transfer of intellectual property; the Made in China 2025 program, which involves self-sufficiency or dominance in a number of critical industries and technologies; cybersecurity; and foreign direct investment.

Part III concerns security issues. Here, again, the topic is broad. We have divided it into four areas: Korea; tensions in the South China Sea and East China Sea; Taiwan, and pressures on the American position in the Western Pacific.

We recognize this is a substantial amount of material and you may not have time to get to it all. However, familiarizing yourself with these papers will prepare you for your discussions in China. Moreover, you should not merely respond to topics the Chinese raise with you, but should take the initiative to raise issues with them.

We are pleased to provide this material and to respond to any questions or suggestions.

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Here are materials drawn from a hearing Senator Gardner chaired on November 7, 2017 at the Senate Foreign Relations Committee. Its title was "American Leadership in the Asia-Pacific, Part 4: View from Beijing." Three witnesses appeared: Dr. Michael Pillsbury from the Hudson Institute, Dr. Graham Allison from Harvard University, and former Ambassador to China Max Baucus. Pillsbury's most recent book is **The Hundred-Year Marathon: China's Secret Strategy to Replace America as the Global Superpower**, published in 2016. Allison's most recent book is **Destined for War: Can America and China Escape Thucydides's Trap?** Ambassador Baucus was, of course, a Senator from 1979 to 2014. President Obama appointed him as Ambassador.

Reference appears in the testimony to Lee Kuan Yew, former Prime Minister of Singapore. Lee, who died in 2015, was one of the world's most informed and perceptive students of geopolitics. In 1994, Fareed Zakharia said in **Foreign Affairs**:

> "One of the asymmetries of history," wrote Henry Kissinger of Singapore's patriarch Lee Kuan Yew, "is the lack of correspondence between the abilities of some leaders and the power of their countries." Kissinger's one time boss, Richard Nixon, was even more flattering. He speculated that, had Lee lived in another time and another place, he might have "attained the world stature of a Churchill, a Disraeli, or a Gladstone."

In 2013, Graham Allison, et. al. prepared a compendium of Lee's commentaries over time. The book is **Lee Kuan Yew: The Grand Master's Insights on China, the United States, and the World.** Chapter One from that book is included here. While Lee was incorrect in forecasting long-term double digit growth for China's economy, his remaining observations were quite prescient.

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Lee Kuan Yew

The Grand Master's Insights on China, the United States, and the World

Interviews and Selections by
Graham Allison and Robert D. Blackwill
with Ali Wyne

Foreword by Henry A. Kissinger

BELFER CENTER STUDIES IN INTERNATIONAL SECURITY
The MIT Press
Cambridge, Massachusetts
London, England

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book, we have resisted the temptation to comment or offer our own views, mindful that presidents and their closest advisers will most benefit from Lee's counsel, not ours.

We have extracted Lee's key insights and central arguments so that they can be scanned quickly. Make no mistake: we believe that every word on every page that follows deserves to be read, but readers can make that judgment for themselves. We suspect that those hoping to make a quick dash through the book will find themselves spending more time than they expected, compelled by Lee's words to pause and think about assertions of his that they find surprising, even disturbing, but invariably illuminating.

The opportunity to spend many hours listening to Lee and poring over his voluminous writings, interviews, and speeches has been more fulfilling than we could have ever expected. If we can offer readers a taste of that banquet, we will have fulfilled our aspirations.

CHAPTER 1

The Future of China

Are Chinese leaders serious about displacing the United States as the number 1 power in Asia? In the world? What does number 1 mean? How will China's behavior toward other countries change if China becomes the dominant Asian power? What is China's strategy for becoming number 1? What are the major hurdles in executing that strategy? How much urgency do China's leaders feel about achieving primacy in their region and beyond? How do China's leaders see the U.S. role in Asia changing as China becomes number 1? Is the double-digit growth that China has maintained over three decades likely to continue for the next several decades? Will China become a democracy? Will China actually become number 1? How should one assess Xi Jinping? These questions are central to the likely course of Asian and world history. Lee Kuan Yew's

thoughtful answers in this chapter reflect decades of observing and analyzing China and its leaders.

⌖

Are Chinese leaders serious about displacing the United States as the number 1 power in Asia? In the world?

Of course. Why not? They have transformed a poor society by an economic miracle to become now the second-largest economy in the world—on track, as Goldman Sachs has predicted, to become the world's largest economy in the next 20 years. They have followed the American lead in putting people in space and shooting down satellites with missiles. Theirs is a culture 4,000 years old with 1.3 billion people, many of great talent—a huge and very talented pool to draw from. How could they not aspire to be number 1 in Asia, and in time the world?[1]

Today, China is the world's fastest developing nation, growing at rates unimaginable 50 years ago, a dramatic transformation no one predicted. . . . The Chinese people have raised their expectations and aspirations. Every Chinese wants a strong and rich China, a nation as prosperous, advanced, and technologically competent as America, Europe, and Japan. This reawakened sense of destiny is an overpowering force.[2]

The Chinese will want to share this century as co-equals with the U.S.[3]

It is China's intention to be the greatest power in the world. The policies of all governments toward China, especially neighboring countries, have already taken this into account. These governments are repositioning themselves because they know that there will be consequences if they thwart China when its core interests are at stake. China can impose economic sanctions simply by denying access to its market of 1.3 billion people, whose incomes and purchasing power are increasing.[4]

Unlike other emergent countries, China wants to be China and accepted as such, not as an honorary member of the West.[5]

What does number 1 mean? How will China's behavior toward other countries change if China becomes the dominant Asian power?

At the core of their mindset is their world before colonization and the exploitation and humiliation that brought. In Chinese, China means "Middle Kingdom"—recalling a world in which they were dominant in the region, other states related to them as supplicants to a superior, and vassals came to Beijing bearing tribute: for example, the sultan of Brunei, who carried silk as his offering, but who died there four centuries ago and now has a shrine in Beijing.[6]

Will an industrialized and strong China be as benign to Southeast Asia as the United States has been since 1945? Singapore is not sure. Neither are Brunei, Indonesia, Malaysia, the Philippines,

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Thailand, and Vietnam. . . . We already see a China more self-assured and willing to take tough positions.[7]

The concern of America is what kind of world they will face when China is able to contest their preeminence. . . . Many medium and small countries in Asia are also concerned. They are uneasy that China may want to resume the imperial status it had in earlier centuries and have misgivings about being treated as vassal states having to send tribute to China as they used to in past centuries.[8]

They expect Singaporeans to be more respectful of China as it grows more influential. They tell us that countries big or small are equal: we are not a hegemon. But when we do something they do not like, they say you have made 1.3 billion people unhappy. . . . So please know your place.[9]

What is China's strategy for becoming number 1?

The Chinese have concluded that their best strategy is to build a strong and prosperous future, and use their huge and increasingly highly skilled and educated workers to out-sell and out-build all others. They will avoid any action that will sour up relations with the U.S. To challenge a stronger and technologically superior power like the U.S. will abort their "peaceful rise."[10]

China is following an approach consistent with ideas in the Chinese television series *The Rise of Great Powers,* produced by the Party to shape discussion of this issue among Chinese elites. The mistake of Germany and Japan was their effort to challenge the

existing order. The Chinese are not stupid; they have avoided this mistake. . . . Overall GDP [gross domestic product], not GDP per capita, is what matters in terms of power. . . . China will not reach the American level in terms of military capabilities anytime soon, but is rapidly developing asymmetrical means to deter U.S. military power. China understands that its growth depends on imports, including energy, raw materials, and food. . . . China also needs open sea lanes. Beijing is worried about its dependence on the Strait of Malacca and is moving to ease the dependence.[11]

The Chinese have calculated that they need 30 to 40, maybe 50, years of peace and quiet to catch up, build up their system, change it from the communist system to the market system. They must avoid the mistakes made by Germany and Japan. Their competition for power, influence, and resources led in the last century to two terrible wars. . . . The Russian mistake was that they put so much into military expenditure and so little into civilian technology. So their economy collapsed. I believe the Chinese leadership has learnt that if you compete with America in armaments, you will lose. You will bankrupt yourself. So, avoid it, keep your head down, and smile, for 40 or 50 years.[12]

To become competitive, China is focused on educating its young people, selecting the brightest for science and technology, followed by economics, business management, and the English language.[13]

My first reaction to the phrase "peaceful rise" was to tell one of their think tanks, "It is a contradiction in terms; any rise is

something that is startling." And they said, "What would you say?" I replied: "Peaceful renaissance, or evolution, or development." A recovery of ancient glory, an updating of a once great civilization. But it is already done. Now the Chinese have to construe it as best they can. A year ago, a Chinese leader in his 70s asked me, "Do you believe our position on peaceful rise?" I answered, "Yes, I do—but with one caveat." Your generation has been through the anti-Japanese war, the Great Leap Forward, the Cultural Revolution, the Gang of Four, and finally the Open Door policy. You know there are many pitfalls, that for China to go up the escalator without mishaps, internally you need stability, externally you need peace. However, you are inculcating enormous pride and patriotism in your young in a restored China. . . . It is volatile." The Chinese leader said they would ensure that the young understood. Well, I hope they do. Somewhere down this road, a generation may believe they have come of age, before they have.[14]

China's strategy for Southeast Asia is fairly simple: China tells the region, "come grow with me." At the same time, China's leaders want to convey the impression that China's rise is inevitable and that countries will need to decide if they want to be China's friend or foe when it "arrives." China is also willing to calibrate its engagement to get what it wants or express its displeasure.[15]

China is sucking the Southeast Asian countries into its economic system because of its vast market and growing purchasing power. Japan and South Korea will inevitably be sucked in as well. It just absorbs countries without having to use force. China's

neighbors want the U.S. to stay engaged in the Asia-Pacific so that they are not hostages to China. The U.S. should have established a free-trade area with Southeast Asia 30 years ago, well before the Chinese magnet began to pull the region into its orbit. If it had done so, its purchasing power would now be so much greater than it is, and all of the Southeast Asian countries would have been linked to the U.S. economy rather than depending on China's. Economics sets underlying trends. China's growing economic sway will be very difficult to fight.[16]

China's emphasis is on expanding their influence through the economy. In the geopolitical sense, they are more concerned now with using diplomacy in their foreign policy, not force.[17]

What are the major hurdles in executing that strategy?

Internally, the chief challenges are culture, language, an inability to attract and integrate talent from other countries, and, in time, governance.[18]

Even if China were as open to talented immigrants as the U.S., how can one go there and integrate into society without a mastery of Chinese? Chinese is a very difficult language to learn—monosyllabic and tonal. One can learn conversational Chinese after a few years, but it is very difficult to be able to read quickly.

I do not know if China will be able to overcome the language barrier and the attendant difficulty in recruiting outside talent unless it makes English the dominant language, as Singapore has.

Children there learn Chinese first. Then they learn **English**. They might go to the U.S. as a teenager and become fluent, but they have 4,000 years of Chinese epigrams in their head.[19]

China will inevitably catch up to the U.S. in absolute GDP. But its creativity may never match America's, because its culture does not permit a free exchange and contest of ideas. How else to explain how a country with four times as many people as America—and presumably four times as many talented people—does not come up with technological breakthroughs?[20]

Can the Chinese break free from their own culture? It will require going against the grain of 5,000 years of Chinese history. When the center is strong, the country prospers. When the center is weak, the emperor is far away, the mountains are high, and there are many little emperors in the provinces and counties. This is their cultural heritage. . . . Chinese traditions thus produce a more uniform mandarinate.[21]

The biggest single fear China's leaders have is the corrosive effect of graft and the revulsion that it evokes in people. They are never quite sure when it will blow up.[22]

There will be enormous stresses because of the size of the country and the intractable nature of the problems, the poor infrastructure, the weak institutions, the wrong systems that they have installed, modeling themselves upon the Soviet system in Stalin's time.[23]

China faces enormous economic problems—a disparity in income between the rich coastal cities and the inland provinces, and

in income within the coastal cities. They have got to watch that carefully or they might get severe discontent and civil disorder.[24]

Technology is going to make their system of governance obsolete. By 2030, 70% or maybe 75% of their people will be in cities, small towns, big towns, mega big towns. They are going to have cell phones, Internet, satellite TV. They are going to be well-informed; they can organize themselves. You cannot govern them the way you are governing them now, where you just placate and monitor a few people, because the numbers will be so large.[25]

Increasingly cheap and available technology and cascades of reverse migration are wising people up to the true story of the exploitation of China's heretofore isolated rural regions. And, furthermore, the Chinese know that with their industrialization, every year, ten or plus millions will go into the new towns they are constructing for their people. . . . If they change in a pragmatic way, as they have been doing, keeping tight security control and not allowing riots and not allowing rebellions and, at the same time, easing up . . . giving more provincial authority, more city authority, more grassroots power, it is holdable.[26]

China did not have to worry about the rest of the world when it was an empire. This time, it has to worry about the rest of the world, because without the resources, the oil, the nickel, whatever, its growth will stop.[27]

Present-day China faces a very advanced North America, Europe, Japan, and a fairly developed Southeast Asia and India. . . . China's leaders 30 years hence will know that although by 2050

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China will be the biggest economy in GNP [gross national product], per capita, they will still be small, and technologically, they will still be way behind. So to get there, they must have a sense of realism. . . . They have got to be like Singapore's leaders, with a very keen sense of what is possible and what is not. They must know that to dominate Asia is not possible.[28]

Straight-line extrapolations from such a remarkable record are not realistic. China has more handicaps going forward and more obstacles to overcome than most observers recognize. Chief among these are their problems of governance: the absence of the rule of law, which in today's China is closer to the rule of the emperor; a huge country in which little emperors across a vast expanse exercise great local influence; cultural habits that limit imagination and creativity, rewarding conformity; a language that shapes thinking through epigrams and 4,000 years of texts that suggest everything worth saying has already been said, and said better by earlier writers; a language that is exceedingly difficult for foreigners to learn sufficiently to embrace China and be embraced by its society; and severe constraints on its ability to attract and assimilate talent from other societies in the world.

While Singapore shares with China many of the core philosophical tenants of Confucianism, we worked over the past 40 years to establish English as our first language, and Chinese as the second. Why? Certainly not by accident or without provoking strong opposition. We did so to open ourselves to the world and allow

ourselves to engage and embrace the main forces of discovery and invention and creativity that occur not only in the language but also in the mentality of English.

We could do that in a small city-state with strong leadership. While I once advised a Chinese leader to make English the first language of China, clearly that is not realistic for such a great, confident country and culture. But it is a serious handicap.[29]

How much urgency do China's leaders feel about achieving primacy in their region and beyond?

The Chinese are in no hurry to displace the U.S. as the number 1 power in the world and to carry the burden that is part and parcel of that position. For now, they are quite comfortable in being part of a larger group like the G20 [Group of Twenty] where their views will be taken seriously and economic interests safeguarded, but the responsibility is shared amongst 20 member states.[30]

While there are no doubt voices calling for China to move more rapidly in establishing its superiority, demanding the respect that comes along with that standing, and exercising this role, the center of gravity among the leaders is cautious and conservative. They operate on the basis of consensus and have a long view. While some may imagine that the 21st century will belong to China, others expect to share this century with the U.S. as they build up to China's century to follow.[31]

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How do China's leaders see the U.S. role in Asia changing as China becomes number 1?

The leadership recognizes that as the leading power in the region for the seven decades since World War II, the U.S. has provided a stability that allowed unprecedented growth for many nations including Japan, the Asian Tigers, and China itself. China knows that it needs access to U.S. markets, U.S. technology, opportunities for Chinese students to study in the U.S. and bring back to China new ideas about new frontiers. It therefore sees no profit in confronting the U.S. in the next 20 to 30 years in a way that could jeopardize these benefits.

Rather, its strategy is to grow within this framework, biding its time until it becomes strong enough to successfully redefine this political and economic order.

In the security arena, the Chinese understand that the U.S. has spent so much more and has built up such advantages that direct challenges would be futile. Not until China has overtaken the U.S. in the development and application of technology can they envisage confronting the U.S. militarily.[32]

What are the Americans going to fight China over? Control over East Asia? The Chinese need not fight over East Asia. Slowly and gradually, they will expand their economic ties with East Asia and offer them their market of 1.3 billion consumers. . . . Extrapolate that another 10, 20 years and they will be the top importer and exporter of all East Asian countries. How can the Americans compete in trade?[33]

I do not see the Americans retreating from Asia. But I see Chinese power growing. The Chinese attitude is: we are not against you; we welcome an American presence—because they know they cannot substitute for the Americans, and the countries here welcome the Americans. So they just wait and grow stronger. Economically and militarily, they may not catch up for 100 years in technology, but asymmetrically, they can inflict enormous damage on the Americans.[34]

Is the double-digit growth that China has maintained over three decades likely to continue for the next several decades?

During the last three decades, China's economy has grown at the phenomenal rate of 10% per year, sometimes even exceeding 12%. Can China maintain such high rates for at least another decade? I think it can. China is starting from a lower base, and its 1.3 billion domestic consumers will keep rates up because their disposable incomes are growing.[35]

Will China become a democracy?

No. China is not going to become a liberal democracy; if it did, it would collapse. Of that, I am quite sure, and the Chinese

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intelligentsia also understands that. If you believe that there is going to be a revolution of some sort in China for democracy, you are wrong. Where are the students of Tiananmen now? They are irrelevant. The Chinese people want a revived China.[36]

Can it be a parliamentary democracy? This is a possibility in the villages and small towns. . . . The Chinese fear chaos and will always err on the side of caution. It will be a long evolutionary process, but it is possible to contemplate such changes. Transportation and communications have become so much faster and cheaper. The Chinese people will be exposed to other systems and cultures and know other societies through travel, through the Internet, and through smart phones. One thing is for sure: the present system will not remain unchanged for the next 50 years.[37]

To achieve the modernization of China, her Communist leaders are prepared to try all and every method, except for democracy with one person and one vote in a multi-party system. Their two main reasons are their belief that the Communist Party of China must have a monopoly on power to ensure stability; and their deep fear of instability in a multiparty free-for-all, which would lead to a loss of control by the center over the provinces, with horrendous consequences, like the warlord years of the 1920s and '30s.[38]

I do not believe you can impose on other countries standards which are alien and totally disconnected with their past. So to ask China to become a democracy, when in its 5,000 years of recorded history it never counted heads; all rulers ruled by right of being the emperor, and if you disagree, you chop off heads, not count heads.

But I agree that in this world of instant communication and satellites, you cannot have barbaric behavior and say it is your internal problem. . . . But now on human rights, they have begun to talk, and they recognize that if they want to be respected in the world community, they want to win a certain status with the rest of the world, not just advanced countries, but even the developing countries, then they cannot behave in a barbaric fashion to their own people.[39]

China discovered that to run a modern state it needed the rule of law. It had a comprehensive set of legal codes by 2035 and found that a stable legal system, together with clear administrative rules, actually strengthened central authority. Erring provincial and local governments were brought to book through due process of law, a method more effective than the endless negotiations that had been the practice before. Also, with the rule of law, ordinary citizens are now protected from the arbitrary authority of officials. Business enterprises are also able to plan large long-term investments. The independence of the judiciary took another 20 years to achieve in practice, because historical tradition, which required magistrates, as officers of the emperor, to carry out imperial orders, was deeply embedded in Chinese officialdom (Lee's 1993 prediction about how Chinese governance would operate in 2150).[40]

Will China actually become number 1?

Their great advantage is not in military influence but in their economic influence. . . . They have the manpower to do things cheaper

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in any part of the world economically. Their influence can only grow and grow beyond the capabilities of America.[41]

The chances of it going wrong in China—if they have pragmatic, realistic leaders who are not ideologically blinkered—are about one in five. I would not say zero, because their problems are weighty ones: system change, business culture change, reducing corruption, and forming new mindsets.[42]

The Chinese have figured out that if they stay with "peaceful rise" and just contest for first position economically and technologically, they cannot lose.[43]

The 21st century will see Asia recover its place in the world. Their progress in the last 30 years entitles East Asians including the Chinese to be optimistic about their future. Short of some major unforeseeable disaster which brings chaos or breaks up China once again into so many warlord fiefdoms, it is only a question of time before the Chinese people reorganize, reeducate, and train themselves to take full advantage of modern science and technology. China will quicken the pace of its development by using inputs from the industrial and newly industrializing countries to catch up with and become, first, a fully industrialized, and next, a high-tech society—if not in 50 years, then in 100 years.[44]

How should one assess Xi Jinping [the likely incoming president of China]?

He has had a tougher life than Hu Jintao. His father was rusticated, and so was he. He took it in his stride, worked his way up the

southern provinces quietly, and rose to become secretary of Fujian Province. Then he went to Shanghai, and then to Beijing. It has not been smooth sailing for him. His life experiences must have hardened him.

He is reserved—not in the sense that he will not talk to you, but in the sense that he will not betray his likes and dislikes. There is always a pleasant smile on his face, whether or not you have said something that annoyed him. He has iron in his soul, more than Hu Jintao, who ascended the ranks without experiencing the trials and tribulations that Xi endured.[45]

I would put him in Nelson Mandela's class of persons. A person with enormous emotional stability who does not allow his personal misfortunes or sufferings to affect his judgment. In other words, he is impressive.[46]

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AS PREPARED FOR DELIVERY

OPENING STATEMENT BY DR. GRAHAM T. ALLISON

BEFORE THE

UNITED STATES SENATE FOREIGN RELATIONS SUBCOMMITTEE ON EAST ASIA, THE PACIFIC, AND CYBERSECURITY POLICY

AT A HEARING CONVENED TO DISCUSS

"AMERICAN LEADERSHIP IN THE ASIA PACIFIC, PART 4: THE VIEW FROM BEIJING"

November 14, 2017

Mr. Chairman, Ranking Member Markey, and Members:

I thank you for the opportunity to testify today on critical questions about "American leadership in the Asia-Pacific: the view from Beijing." My grandfather was fond of quoting a line from the Old Testament book of Proverbs that says: "oh, that my enemy had written a book." On the array of questions that you have posed for the members of this panel, I have written a book entitled Destined for War: Can America and China Escape Thucydides's Trap? The book was published on Memorial Day and I have been gratified by the responses from reviews in all the major newspapers and journals, including the front page of the Sunday *New York Times Book Review*, as well as the speed with which the major arguments of the book have entered the policy mainstream, both in Washington and Beijing. Indeed, at the 19th Party Congress that just concluded in Beijing, Xi Jinping was talking, among other things, about Thucydides's Trap.

If required to summarize the core argument of the book in a few bullet points, it is that:

- When a rising power threatens to displace a ruling power, alarm bells should sound: danger ahead. Thucydides's Trap is the dangerous dynamic that occurs in this interaction. In the case of the rise of Athens and its impact upon Sparta (which had ruled Greece for 100 years), or Germany in its rivalry with Britain a century ago in the run up to World War I, or China over the past generation as it has come to rival, and in many areas, surpass the

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US, this dangerous dynamic creates conditions in which both competitors are acutely vulnerable to provocations by third party actions. One of the primary competitors feels obliged to respond and there follows a cascade of actions and reactions at the end of which the two find themselves in a war neither wanted. Ask yourself again: how did the assassination of a minor archduke start a fire that burned down the whole of Europe at the beginning of the past century? How did North Korea drag China and the US into war 67 years ago last month?

- Destined for War examines the past 500 years and finds 16 cases in which a rising power threatens to displace a ruling power. Twelve of these cases ended in war; four without war. Thus to say that war between a rising China and a ruling US is inevitable would be mistaken. But to say the odds are against us would not be.
- This book is neither fatalistic nor pessimistic. Instead, its purpose is to help us recognize that these structural factors create extreme dangers that require extreme measures on the part of both the US and China—if we are to escape Thucydides's Trap. As I argue in the book, business as usual (which is what we have seen for the last two decades under both Democratic and Republican leadership) is likely to lead to history as usual. And in this case, that would be a catastrophic war that no one in Beijing or Washington wants. Indeed, every serious leader in both capitals knows that would be crazy. But none of the leaders of the major powers in 1914 wanted World War I. Neither China nor the US wanted war in 1950. The good news is that, as Santayana taught us, only those who refuse to study history are condemned to repeat it. We are under no obligations to repeat the mistakes made by Kaiser Wilhelm in 1914 or Pericles in classical Greece that led to war.
- In sum, the purpose of the book is to help us diagnose the condition which we now find ourselves in. My thesis is certain to frustrate Washingtonians—since the Washington template demands a solution to a problem in the same sentence in which the challenge is identified. In my view, that is one of the major problems with "Washington solutions." We must recognize that a rising China is not a "fixable" problem but rather a condition that we will have to cope with for a generation. Success in meeting this grand challenge will require a surge of imagination and adaptability as remarkable as that demonstrated by individuals we now celebrate as the "wise men" who created the Cold War strategy that we sustained for four decades until success was at last achieved.

Your invitation for me to testify identified ten questions. Perhaps I can be most helpful by summarizing brief answers to each.

1. What is your assessment of Chinese strategic intentions in the Asia-Pacific region, and globally, over the short, medium, and long term? How will China advance those intentions?

I posed this question two years ago to the individual who was unquestionably the world's premier China watcher until his death in 2015. Specifically I asked

him: "are China's current leaders, including Xi, serious about displacing the US as the predominant power in Asia in the foreseeable future?"

I cannot improve on his answer. Lee Kuan Yew responded: "Of course. Why not? How could they not aspire to be number one in Asia and in time the world?"

Lee foresaw the twenty-first century as a "contest for supremacy in Asia." China's leaders see this as what they call a "prolonged struggle" over international order—especially in their neighborhood. This does not mean that Xi and his colleagues want war. Precisely the opposite. Instead, they are attempting to follow Sun Tzu's maxim: "Ultimate excellence lies not in winning every battle, but in defeating the enemy without ever fighting." As Henry Kissinger's explains, for the Chinese this means that "far better than challenging the enemy on the field of battle is maneuvering him into an unfavorable position from which escape is impossible." In economic relations today, China is doing just that to its Asian neighbors and indeed to the US.

China primarily conducts foreign policy through economics because, to put it bluntly, it can. It is currently the largest trading partner for over 130 countries — including all the major Asian economies. As China's dominant economic market and its "One Belt, One Road" plan to network Asia with physical infrastructure (at a scale 12 times that of the Marshall Plan) draws its neighbors into Beijing's "economic gravity," the United States' post-World War II position in Asia erodes.

2. How does the Chinese leadership view the United States and its role in the region and the world?

In 2014, former Australian Prime Minister Kevin Rudd and U.S. National Security Advisor Brent Scowcroft each came back from separate, extensive conversations with Chinese leaders with identical views of what they call the striking "consensus" in the Chinese leadership. According to both statesmen, China's leaders believe that America's grand strategy for dealing with China involves five "to's": to isolate China, to contain China, to diminish China, to internally divide China, and to sabotage China's leadership. As Rudd explained, these convictions "derive from a Chinese conclusion that the US has not, and never will, accept the fundamental political legitimacy of the Chinese administration because it is not a liberal democracy." Moreover, according to Rudd, this is based on "a deeply held, deeply 'realist' Chinese conclusion that the US will never willingly concede its status as the preeminent regional and global power, and will do everything within its power to retain that position." Or, as Henry Kissinger says plainly, every Chinese leader he has met believes that America's strategy is to "contain" China.

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When I asked a Chinese colleague in their security community what he thought the US role in the region should be, he answered: "back off." His own colleague proposed a more candid two-word summary: "butt out." As realistic students of history, Chinese leaders recognize that the role the US has played since World War II as the architect and underwriter of regional stability and security has been essential to the rise of Asia, including China itself. But they believe that as the tide that brought the US to Asia recedes, America must leave with it. Much as Britain's role in the Western Hemisphere faded at the beginning of the twentieth century, so must America's role in Asia as the region's historic superpower resumes its place. As Xi told a gathering of Eurasian leaders in 2014, "In the final analysis, it is for the people of Asia to run the affairs of Asia, solve the problems of Asia and uphold the security of Asia."

Prior to last week's APEC meeting in Da Nang, China persuaded Vietnam to negotiate their South China Sea dispute through direct talks without the US, and the Philippines to end construction of facilities on Thitu Island, which China claims. As China's Ambassador to the US put it: "I think it would certainly be better if others including the United States would not try to interfere in this constructive process." At the conclusion of last week's meeting with President Trump, Xi noted that "the Pacific Ocean is vast enough to accommodate both countries" But as China's aggressive deployment of modern anti-ship missiles with longer and longer ranges keeps nudging US aircraft carriers further and further from its shores, one suspects that Xi hopes to persuade Trump to a division of spheres of influence on either side of Hawaii.

3. How is China's regional and global posture taking shape under President Xi Jinping? What is your perspective on the outcomes of the recent 19th Party Congress?

In his speech at the 19th Party Congress, President Xi was very clear about China's posture today. He said: "the Chinese nation now stands tall and strong in the East; no one should expect China to swallow anything that undermines its interests." Moreover, he was bold enough to put a target objective and a date together, declaring China's intention to become "global leader in terms of composite national strength and international influence" by 2050. If, by mid-century, China achieves a per capita GDP equivalent to that of the US, its economy will be four times larger than ours—since it has four times as many people.

Anyone who doubts Xi's ambitions for China should listen to the declaration of his own sense of the march of history captured in a line that has not been reported by English-language media. He declared: "History looks kindly on

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those with resolve, with drive and ambition, and with plenty of guts; it won't wait for the hesitant, the apathetic, or those shy of a challenge." That should give you an idea about his posture.

4. How has the United States' view of China evolved over the past century, and how do you see it evolving in the decade ahead?

To put it in one line, the US has assumed that, as it matured, China would become "more like us." Particularly after the Cold War ended abruptly in 1991 with the collapse of the Soviet Union, most of the American foreign policy establishment took a victory lap in which we engaged in more than a little triumphalism. Celebrating the US position as the Unipolar Power, Frank Fukuyama famously declared the End of History. Democratic capitalism had swept the field and hereafter nations would follow our lead first in adopting market capitalism in order to grow rich. As they developed a middle class, they would become democracies. And according to the "democratic peace" hypothesis, war would become obsolete since democracies do not fight each other. Thomas Friedman popularized this argument with his "Golden Arches" theory, declaring that two nations that had McDonald's Golden Arches could not fight each other.

Obviously, this victory lap was premature. Americans are now waking up to the fact that, as Lee put it, a powerful China will insist on "being accepted as China, not as an honorary member of the West."

5. What is your perspective on the Obama Administration's "Asia Pivot" or "rebalance" policy, and what policy should the Trump administration pursue with respect to the Asia-Pacific, and China in particular?

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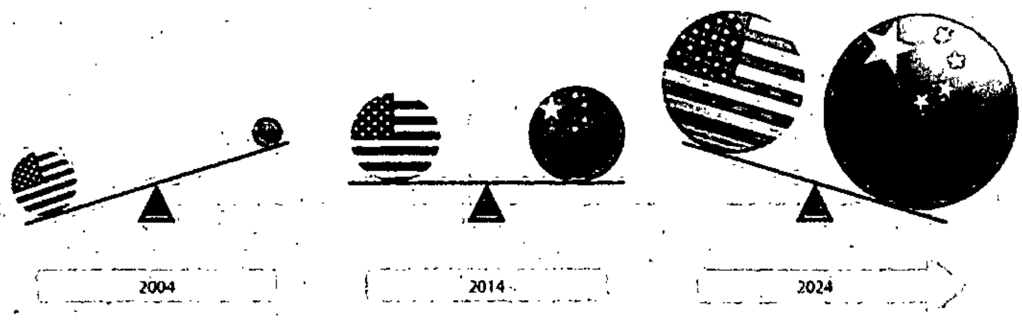
Who's Rebalancing Whom?



GDP (PPP) in billions of dollars

	2004	2014	2024 est.
China	5,760	18,228	35,596
U.S.	12,275	17,393	25,093

Source: IMF, Economist Intelligence Unit

This illustration comes from my testimony to the Senate Armed Services Committee in 2014. It compares the relative weight of the US and Chinese economies as if they were two competitors on opposite ends of a seesaw. While we have been debating whether we should put less weight on our left foot (the Middle East) in order to put more weight on our right (Asia), China has just kept growing — at three times the US rate. As a result, America's side of the seesaw has tilted to the point that both feet will soon be dangling entirely off the ground.

What strategy should the Trump Administration adopt to deal with this challenge? I wish I knew. I wish anybody knew. But truth be told, I am still struggling to diagnose our challenge. As I argue in DFW, diagnosis must precede prescription. If when one walks into a doctor's office, he immediately proposes to put you on the trolley and roll you into the operating room for surgery, beware. Washingtonians live by the creed: "don't just stand there, do something." But I believe that we need first to understand the shape of the challenge we face. There is no "solution" for the dramatic resurgence of a 5,000-year old civilization with 1.4 billion people.

What America needs most at this moment is not a new "China strategy," but instead a serious pause for reflection, followed by a surge of strategic imagination as penetrating as that displayed by those "wise men." In short, it will demand something far beyond anything we have seen since the opening to China.

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What I will say is that the strategy toward China that America has followed since the end of the Cold War, known as "engage but hedge," is fundamentally flawed: it is a banner that permits everything and prohibits nothing. It relies on balancing China while hoping that China will become a liberal democracy, or at least accept a subordinate place in the American-led international order. It should now be obvious that this is not going to happen. If the US just keeps doing what it has been doing, future historians will compare American "strategy" to illusions that British, German, and Russian leaders held as they sleepwalked into WWI.

6. **What is the current state of China-North Korea relations? How have they evolved in recent years? Given China's desire to avoid a collapsed state and/or having the US military close to its borders, how much pressure can China be expected to apply to North Korea?**

China-North Korea relations are worse than ever before. Outraged by Beijing's support for sanctions, some North Korean statements have even begun implicitly threatening China, noting that North Korea's missiles can fly in any direction. Chinese internet users commonly refer to Kim Jong Un as "Little Fatty" and reportedly Xi Jinping personally cannot stand him. When Kim tested a missile during Xi's important BRICS Summit, Xi took it as a serious personal insult.

However, the strategic situation has not fundamentally changed for China. They see stability on the Korean Peninsula, even with an antagonistic neighbor, as preferable to any feasible alternative. They remain unwilling to support any action that would lead to the collapse of the regime. And they continue to see the biggest anomaly on the peninsula as the presence of the US.

7. **How likely is it that a US-North Korea military conflict would trigger a wider Sino-American war? Under what circumstances might we expect China to intervene (or not intervene) in an American conflict with North Korea?**

Anyone who finds it hard to believe that a military conflict with North Korea could drag the US into war with China should remember 1950. In June of 1950, a Communist North Korea lad by KJU's grandfather attacked South Korea and almost succeeded in reunifying the country under his control. The US came to the rescue at the last minute and US troops pushed the North Koreans back up the peninsula, across the 38th

parallel, and rapidly approached the Chinese border. McArthur expected to wrap things up before Christmas so that US troops could come home. The possibility that China, which just the year before had consolidated control of its own country after a long, bloody civil war, would attack the world's sole superpower, who just five years earlier had dropped atomic bombs on Hiroshima and Nagasaki, was for McArthur inconceivable. But he awoke one morning in October to find his forces attacked by a "peasant army" of 300,000 Chinese who beat the US back down the roads they had come up, to the 38th parallel, where the US was forced to settle for an armistice. Tens of thousands of Americans, hundreds of thousands of Chinese, and millions of Koreans died in that war.

Chinese believe that Mao established the proposition that Korea would never become a unified state under the control of an American military ally. As they put it pointedly, if we were prepared to fight to make that point in 1950 when we were 1/50th your size, it should not be necessary to test that proposition again with a China that now has a GDP larger than that of the US.

China has considered Korea to be its vassal state since 670AD. And for China the prospect of South Korea conquering the North and bringing US troops to China's borders is as unacceptable today as it was in 1950. Expect China to intervene in some fashion on the peninsula in almost any military scenario—even if only to seize and hold a buffer zone in the north, as Chinese troops have recently been drilling to do.

Even if Chinese forces entered North Korea with no intention of fighting the US, there are many scenarios in which war could still occur through miscalculation, including a "vertical track meet" between Chinese and US special forces rushing to secure the North's nuclear weapons in the event of a regime collapse. These weapons are held near China's borders, so it is very likely that if and when US troops arrive, they will find Chinese special forces already there.

8. What diplomatic role can China play to defuse tensions between the US and North Korea, and advance diplomacy to denuclearize the Korean peninsula?

The immediate cause of tension between the US and North Korea is North Korea's drive to develop a credible threat to strike the American homeland with nuclear weapons, on the one hand, and President Trump's determination to do whatever is required to prevent that from happening, on the other. This is the dynamic that will in the next 12 months take us

to one of three destinations: (1) North Korea will have completed the next series of ICBM tests and be able to hold American cities hostage; (2) Trump will have ordered airstrikes on North Korea in an attempt to prevent that from happening; or (3) a minor miracle in which Xi and Trump, working together, convince Kim to halt his nuclear advance.

China controls North Korea's oil lifeline. If it squeezes that pipeline, North Korean aircraft, tanks, missile launchers, trucks, cars and factories will feel the pain. China has been reluctant to exercise this influence for fear of how Kim might react. But after recent provocations, Chinese officials have begun signaling that Xi might be willing to take that risk.

Careful watchers of last month's 19th Party Congress in Beijing have noted the dog that did not bark. During the coronation of China's new emperor, the only peep from Pyongyang was a letter of congratulations from Kim. This caution carried over to the meetings between Trump and Xi last week, which Kim did not greet with another nuclear or missile test as some feared he would.

If Trump and Xi seek to hammer out a joint plan for stopping Kim from further ICBM and nuclear tests, what could that look like? The Chinese government has offered a formula it calls "freeze for freeze." North Korea would stop testing for the year ahead and the U.S. would stop or significantly modify joint U.S.-South Korean military exercises that Kim despises. The U.S. has rejected that idea outright. But if Trump recognizes that the only alternatives are the two previously mentioned, it should be possible to find adjustments the U.S. could make in exercises, bomber flights and troop levels in South Korea that, while uncomfortable and ugly, do not compromise anything vital. Whether that would be sufficient to persuade Xi to threaten Kim's oil lifeline, and whether Kim would accept a freeze for freeze, is uncertain. And even if such a deal were possible, this would only kick the can down the road for another year.

Nonetheless, given where events stand today, if Trump and Xi can find their way to cooperate to produce this minor miracle, we should all give thanks.

9. Other than North Korea, what flashpoints do you see that could trigger military conflict between the US and China?

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The dangerous dynamic of Thucydides's Trap leaves both parties vulnerable to actions by third parties, or events that would otherwise be inconsequential or readily managed, but that trigger reactions by the primary competitors that lead to war. Chapter 8 of my book is titled "From Here to War." It sketches five all-too-plausible scenarios that could escalate mundane crises into a war that neither the US nor China wants: North Korea; an accidental collision in the South China Sea; a move by Taiwan toward independence; a clash between China and Japan in the East China Sea; and an economic conflict that escalates into a shooting war.

I am ready to describe each in detail if members are interested.

10. How do you assess President Trump's visit to the region?

One is reminded of Zhou Enlai's response to Henry Kissinger when Kissinger asked him how he assessed the French Revolution. Zhou said: "it's too soon to tell."

Overall, the trip seems to have been more successful than most observers had expected. Through a twelve day marathon, an individual known not to like to travel or to participate in big meetings with foreign leaders played his role and stayed on script. Since his primary objective was to develop support for stopping KJU's nuclear advance, the fine words we heard both from Trump and from all his counterparts are good enough. But the proof of what was accomplished on this front—or not—will be in actions we see in the weeks ahead.

The Trump Administration's choice to focus on Xi and to do whatever it can to persuade him to rein in KJU was, in my view, the best of the feasible approaches available—given the realities they inherited in January. Whether Xi believes that if he fails to stop KJU from conducting another series of ICBM tests, Trump will order US strikes, time will tell. As noted above, I am hoping and indeed praying for a miracle. But as an old Pentagon hand, I know that hope and prayer alone are not a sufficient plan.

For more on my thoughts about the North Korean challenge, I have attached two op-eds from the past two weeks that summarize my views.

I trust that I have said enough to be responsive to your assignment and I look forward to the discussion.

Graham Allison, "Will Trump and Xi 'Solve' North Korea?" *Politico*, 11/8/17

The centerpiece of President Donald Trump's conversation with Chinese President Xi Jinping on Thursday will doubtless be North Korea. Before their first meeting in April, Trump's message to Xi was unmistakable: You solve this problem, or I will, and you won't like the way I do it. Then, just after he served Xi and his wife chocolate cake at Mar-a-Lago, Trump excused himself and went to an adjacent room to announce that the U.S. was launching 59 cruise missiles against Syria. Message: I'm serious.

Trump has repeatedly complained that his predecessors left him a mess in North Korea, with an emboldened regime in Pyongyang that threatens to soon have a credible capability to hit the United States with a nuclear weapon. "It should have never been given to me," he told an interviewer in October. "This should have been

solved long before I came to office, when it would have been easier to solve. But it was given to me and I get it solved. I solve problems."

But will Trump really "solve" North Korea? The answer is most certainly no. Indeed, I am so confident in answering no that I am prepared to bet $100 of my money—against $1 of anyone who wants to wager—that when Trump leaves office, a nuclear-armed North Korea will remain a major challenge for his successor.

Why is the North Korea challenge essentially unsolvable? Because of brute realities that defined the problem before Trump arrived. Specifically, when he entered office nine months ago, North Korea already had dozens of nuclear weapons, as well as short- and medium-range missiles that could deliver them against South Korean and Japanese cities. Moreover, it stood on the cusp of an intercontinental ballistic missile capability to credibly threaten attacks on San Francisco and Los Angeles.

Well before Trump mounted his campaign for the presidency, Kim Jong Un had concluded that the surest way to protect his regime from an attack by the U.S. was a sturdy nuclear security blanket. North Korean leaders listened carefully to President George W. Bush's 2002 State of the Union address when he famously named an "axis of evil": Iraq, Iran and North Korea. Bush then proceeded to launch a massive attack against Iraq, the only one of the three that had no nuclear weapons or serious nuclear weapons program. A decade later, Bush's successor joined the British and French in an extensive air campaign against Libya that overthrew Muammar Qadhafi, who just eight years earlier made a deal with the U.S. to give up his nuclear weapons program. As Bush's Undersecretary of Defense Eric Edelman later quipped, we taught bad guys around the world that "if you have no nuclear weapons, we will invade you; but if you give up your nuclear weapons program, we will only bomb you."

If these realities make it impossible for Trump to "solve" North Korea, what can he hope to achieve on this Asia odyssey?

Jump ahead a year to November 2018. At that point, we will know what happened in the current stare-down between Kim and Trump. There are three possibilities: (1) North Korea will have completed the next series of ICBM tests and be able to hold American cities hostage; (2) Trump will have ordered airstrikes on North Korea to prevent that happening; or (3) a minor miracle will have avoided the first two possibilities.

The safest posture is to hedge one's bets, or even better, to craft a Delphic pronouncement that sounds profound but leaves sufficient wiggle room to allow one to claim to have been right whatever happens. But if forced to place my bet, I'd wager that Kim wins. He will conduct the tests, and U.S. intelligence will report that he now has a credible threat to hit the continental United States. Of course, he would never do that—or at least almost never. He knows that doing so would mean committing suicide for himself and his regime. Nonetheless, Americans will be living in a significantly more dangerous world.

If required to quantify my odds, I put the first option (No. 1 listed above) at 50 percent. For the rest, saving 10 percent for possibilities beyond the three I am currently able to identify, I would split the remainder: betting that there is a 25 percent chance of a U.S. attack and a 15 percent chance of a miracle.

Currently, most of Washington's national security experts are not only expecting, but even hoping for the first option, since they find the second unacceptable and the third too remote a possibility to believe. Unfortunately, most have not yet recognized how dangerous that world will be.

Why will it be more dangerous than the challenge we face today? Because Kim will be emboldened by his success. He will have gone eyeball to eyeball with the leader of the most powerful country in the world and forced him to blink. He will have trumped Trump.

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What can we look for in Kim's next act? If he follows his father's and grandfather's script, watch for coercive extortion. In response to Kim's tests, the U.S. will further tighten sanctions to threaten the regime's economic survival. His response will remind us of former Secretary of Defense Robert Gates's observation: North Korea will "sell anything they have to anybody who has the cash to buy it." A nation known in U.S. intelligence circles as "Missiles-R-Us" will threaten to become "Nukes-R-Us."

Could North Korea sell nuclear weapons to another rogue state? The U.S. would warn the regime that this would cross an inviolable red line. But what could we threaten that Kim would believe we would actually do? He will reflect on the fact that the U.S. was not prepared to attack North Korea to prevent it from acquiring an ability to strike the American homeland. For what else would it risk war—other than a full-scale attack on the U.S. or an American ally?

The second option, particularly if it involves a limited cruise-missile attack like the one Trump launched in Syria, is operationally feasible and can interrupt Kim's ICBM tests. The question is: How will Kim respond? Most U.S. intelligence analysts believe he will shell Seoul with conventional artillery. Just last week, a high-level North Korean defector told Congress that this is the plan. North Korea has long deployed and regularly practiced the use of this threat to Seoul. Killing tens of thousands of people overnight would not be that difficult.

In order to stop the firing that could kill hundreds of thousands more, South Korea and the U.S. would conduct strikes to destroy these long-range artillery guns and other missiles and rockets poised to hit the South.

This would mean attacks on several thousand aim points. Even if the effort was successful in significantly limiting the number of additional bombs exploding in South Korea, the consequence of the attack would almost certainly be the initiation of a Second Korean War. And the further wild card that cannot be wished away is North Korea's substantial nuclear arsenal and missiles.

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When asked about this scenario by Congress, Secretary of Defense James Mattis has repeatedly insisted that such a war would be "catastrophic." He has reminded members of Congress that in the first Korean War, tens of thousands of Americans, hundreds of thousands of Chinese and millions of Koreans died.

Mattis has also assured Congress that at the end of such a war, the U.S. would win and the Kim regime would be gone. The question he has not addressed, however, is what China would do. The Chinese security community has been as loud and clear as it could be that Beijing would never allow a unified Korea that is an American military ally. That, they say, was the big lesson from the first Korean War.

Which brings us to pray for a minor miracle in which Xi and Trump, acting together, persuade Kim to halt his nuclear advance. This is not quite as far-fetched as it may seem at first glance. Xi has found Kim almost as frustrating as Americans have. Repeatedly, Kim has demonstrably dissed Xi by launching missiles or testing nuclear weapons to "celebrate" major events in Beijing: the BRICS [Brazil, Russia, India, China, South Africa] Summit, the grand announcement of Xi's multitrillion dollar One Belt One Road Initiative, the visit of Secretary of State Rex Tillerson to plan for the summit in Beijing with Trump.

China controls North Korea's oil lifeline. If it squeezes that pipeline, North Korean aircraft, tanks, missile launchers, trucks, cars and factories will feel the pain. China has been reluctant to exercise this influence for fear of how Kim might react. But after recent provocations, Chinese officials have begun signaling that Xi might be willing to take that risk.

Careful watchers of last month's 19th Party Congress in Beijing have noted the dog that did not bark. During the coronation of China's new emperor, the only peep from Pyongyang was a letter of congratulations from Kim. Whether this caution will carry over to the meetings between Trump and Xi on Thursday we will soon see.

If Trump and Xi seek to hammer out a joint plan for stopping Kim from further ICBM and nuclear tests, what could that look like? The Chinese government has offered a formula it calls "freeze for freeze." North Korea would stop testing for the year ahead and the U.S. would stop or significantly modify joint U.S.-South Korean military exercises that Kim despises. The U.S. has rejected that idea outright. But if Trump recognizes that the only alternatives are the two we have discussed, it should be possible to find adjustments the U.S. could make in exercises, bomber flights and troop levels in South Korea that, while uncomfortable and ugly, do not compromise anything vital. Whether that would be sufficient to persuade Xi to threaten Kim's oil lifeline, and whether Kim would accept a freeze for freeze, is uncertain. And even if such a deal were possible, this would only kick the can down the road for another year.

Nonetheless, given where events stand today, if Trump and Xi can find their way to cooperate to produce this minor miracle, we should all give thanks. Indeed, having found out what they can achieve when the U.S. and China are prepared to be more imaginative and adaptive in cooperating, they might find ways to go further, and begin rolling back Kim's nuclear program. And even this partial success would lay a foundation for managing other arenas where the Thucydidean dynamic of a rising power's threat to displace a ruling power creates serious risks of catastrophic war.

Would I bet on this happening? Nope. But I hope it does.

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Graham Allison and Michael Morell, "North Korea Crisis Presents Risk, But Also Opportunity for U.S. and China," *Cipher Brief*, 10/22/17

Most discussions about the North Korea nuclear threat focus on the risk of conflict between the U.S. and North Korea. Serious as that is, an even more important issue is what the crisis will mean for the U.S. and China – the world's most consequential relationship. Great risk and great opportunity abound.

Will the 21st century be defined by great power war or peace? By prosperity or poverty? The answers depend largely on the course set by Washington and Beijing. But as powerful as both are, each is subject to structural forces not of their own making. Today, as a rising China threatens U.S. predominance in Asia and the international order the U.S. has underwritten for the past seven decades, both sides are locked in the Thucydides Trap. (Thucydides, the ancient Greek historian, was the first to identify the natural tensions between a rising power and the ruling

power it seeks to displace – in his case, Athens and Sparta – that can lead to conflict.)

This dynamic leaves the U.S. and China vulnerable to the decisions of third parties: actions that would otherwise be inconsequential or easily managed can trigger reactions by the great powers that lead to disastrous outcomes neither wanted. How else could the assassination of a minor archduke in Sarajevo in 1914 have produced a conflagration so devastating that it required historians to invent an entirely new category – "world war"? In the antics of the erratic (but rational) young leader of North Korea, whom the Chinese security establishment calls "little fatty," it is not hard to hear echoes of 1914. The challenge for leaders in Washington is to deal with the acute crisis while also developing ways to cope with the underlying challenge in the relationship.

What is the risk? In the next six to 12 months, either Kim Jong-un is going to demonstrate that he can reliably put a U.S. city at risk of nuclear attack and we are going to (reluctantly) accept that, or President Trump is going to try to prevent that from happening by ordering U.S. airstrikes on North Korea. Remember: upon becoming president-elect, Trump vowed that he would not allow North Korea to develop the capability to hit the U.S. with a nuclear weapon. A cruise missile attack like the one Trump ordered on Syria after the opening dinner for Chinese President Xi Jinping at Mar-a-Lago is not difficult to execute. The question is what would come next.

No one knows for sure. But the best judgment of North Korea experts is that the North will respond by raining artillery shells down on Seoul – the center of which is just 35 miles from the border between South and North Korea – killing tens of thousands or even hundreds of thousands of its more than 25 million citizens in just the first 24 hours of fighting. It is simply not possible for a U.S. preemptive strike to remove all the North Korean artillery along the border before it can fire on Seoul.

As that is occurring, what will South Korea and the U.S. do? Again, while nothing is automatic, plans call for the obvious: attacks on the weapons that are firing against Seoul. In addition to the artillery on the border, the U.S. and South Korean counterattack would almost certainly target the several thousand other North Korean rockets and missiles that could attack South Korea (including missiles that could carry nuclear warheads). Whether that attack would also attempt to kill Kim Jong-un and the leadership in Pyongyang involves another decision by the President. But the critical point is that after a U.S.-South Korean response against several thousand targets in the North, the second Korean War would have begun.

Secretary of Defense Mattis has offered his considered assessment of such a war in recent testimony before Congress. He has warned candidly that a second Korean conflict would be catastrophic, causing loss of life, including both U.S. combatants and U.S. civilians living in South Korea, unlike any we have seen since the first Korean War. But he has also assured members of Congress that at the end of that war the U.S. would "win," Korea would be unified, and the Kim regime would be gone.

The question he has not addressed, and which no member of the committees before which he has testified has asked him, is: "what about China?" That was the question General Douglas MacArthur infamously failed to consider in October 1950, when U.S. troops who had come to the rescue of South Korea pushed the North Korean aggressors back up the peninsula. MacArthur imagined that he would unify the country and start bringing American troops home before Christmas. Since this was just five years after the U.S. had ended World War II by dropping atomic bombs on Hiroshima and Nagasaki, and less than a year after Mao had won a long, bloody civil war, the thought that a nation with a GDP one fiftieth the size of America's would attack the world's uncontested superpower was inconceivable. But Mao did. And his force of 300,000 fighters, followed by a second wave of half a million, beat American forces back down the peninsula to the 38th parallel where the U.S. had to settle for an armistice.

As a member of the Chinese security establishment explained to one of us in a recent conversation, Beijing will not permit a united Korea allied with the U.S. on its border. From a Chinese perspective, that point was written in blood when Mao's China entered the first Korean War. And they will do so again if Beijing believes that is the U.S. intention or the likely result of a U.S. and North Korean conflict. Indeed, just last month, the Chinese warned publicly that if the U.S. preemptively attacked North Korea, China would fight on behalf of Kim Jong-un.

This is a not a war we would want the U.S. to fight. No one should forget that the first Korean War claimed the lives of tens of thousands of Americans, hundreds of thousands of Chinese, and millions of Koreans. With China's extensive military modernization over the last two decades, particularly the deployment of weapon systems designed to deny U.S. access to the battlefield, the Chinese might even win the war — or force the U.S. to settle again for an equivalent of the armistice accepted in 1953. Such outcomes would mark a turning point in the balance of power in East Asia, if not the world. After World War II, the U.S. emerged as the leading global power. After a second Korean War, China might wear that mantle.

A similar risk of conflict between the U.S. and China exists in the other, and perhaps more likely, path that the U.S. could take in the near-term regarding the North Korean nuclear crisis – acceptance of the North's nuclear weapons capability along with containment and deterrence to deal with the threat. The problem with this option is not only that it leaves Kim with an ability to strike the U.S. homeland with nuclear weapons but also that Kim could see that capability as a tool to coerce the U.S. and South Korea to get what he wants – first, the withdrawal of U.S. forces from the Peninsula and second, reunification on his terms. Kim could calculate that since the U.S. was not prepared to risk war to prevent it acquiring the capability to attack American cities, the U.S. would not be willing to trade Chicago for Seoul. And, in taking provocative actions based on this assumption, Kim could bring the U.S. and North Korea to war – again with the risk of China joining the fight.

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What then is the opportunity? Our vital national interest in North Korea is to ensure that Kim Jong-un cannot threaten the U.S. and our allies and partners with nuclear weapons. China shares this interest because Beijing understands that as the North Korean threat grows, the U.S. and its allies will move to protect themselves with missile defense, a development that would also put Chinese missiles and therefore China's deterrence at risk. Beijing also knows that South Korea and Japan may well respond to a North Korea armed with nuclear-tipped missiles by developing their own nuclear weapons, a serious and threatening development from China's perspective.

Given these converging interests, can we imagine American and Chinese diplomats finding common ground on a vision for the future of the Korean Peninsula — one without nuclear weapons — and developing a cooperative approach to achieve it that might start with significant limits on what North Korea has at present? If such cooperation were to result in eventual denuclearization of the North and enhanced stability in Northeast Asia, it would act as a bright shining beacon of what the U.S. and China could achieve working together. It would build trust in both capitals. It would be a major step forward in managing the Thucydidean tension in the relationship and pushing the two countries away from conflict and toward cooperation.

How do we get to a place with the Chinese where we can have such a conversation about North Korea? It cannot be through threats. We cannot achieve this by publicly scolding China over not doing more to pressure Kim Jong-un, by publicly raising the prospect of war between the U.S. and North Korea in an effort to frighten Beijing into action, or by publicly offering China a deal whereby they pressure North Korea in exchange for the U.S. backing away from action on Chinese trading practices. None of these will move China to act. They are too proud a nation and a culture to be bullied, bribed, or threatened into action.

Rather, the potentially productive path forward is to sit and talk turkey with the Chinese – in private, even secretly – about their real national interests and ours.

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President Trump and President Xi should ask one or more of their most trusted senior officials to sit down for several days of hard conversation and come back with feasible, if ugly, options for a joint way forward.

For inspiration, they could read the transcripts—now declassified—of the initial conversations between Henry Kissinger (as Nixon's national security adviser) and Zhou Enlai (Mao's most trusted lieutenant). They could reexamine what John F. Kennedy did when he came to the final fork in the road confronting the Soviet Union over its attempt to place nuclear-tipped missiles in Cuba. They could consider what Obama did in sending Bill Burns and Jake Sullivan to secret talks that developed a path to prevent (or at least postpone for a decade) Iran's quest for nuclear weapons.

Critics will shout: "but in every one of these cases the U.S. compromised!" Yes, to achieve what these presidents judged vital for our country, they sacrificed other interests. To open relations with China in order to encourage its split from the Soviet Union, Nixon and Kissinger agreed to de-recognize Taiwan as the government of China and recognize Beijing (a decision that was officially implemented under President Carter). To escape the choice between accepting an operational Soviet nuclear base in Cuba and an attack on the missiles, Kennedy promised—secretly—that if the Soviet missiles were withdrawn, six months later, equivalent U.S. missiles in Turkey would be removed. And as Iran's nuclear program had advanced to a point that it stood just 2 months away from its first nuclear bomb, Obama signed an agreement that allowed Iran to keep a limited uranium enrichment program in exchange for pushing its nuclear program back to at least a year away from a bomb.

Ronald Reagan was determined to bury Communism. But to advance that cause, he repeatedly engaged in negotiations with the Soviet Union and reached arms control agreements that constrained or even eliminated American nuclear and missile programs as the price of stopping Soviet advances that threatened us. For this, many conservative supporters attacked Reagan. For example, George Will accused

Reagan of "accelerating moral disarmament" and predicted that "actual disarmament will follow." But as Reagan's Secretary of State George Shultz noted: "Reagan believed in being strong enough to defend one's interests, but he viewed that strength as a means, not an end in itself. He was ready to negotiate with adversaries and use that strength as a basis of the inevitable give-and-take of the negotiating process."

To persuade China to join us in taking responsibility for North Korea, and use its leverage to stop Kim's nuclear advance and begin rolling back his program, what incentives could Trump's secret negotiators offer as a reward for success? The Trump Administration and its predecessors have insisted that we will not make changes in our own military forces to reward North Korea or China for stopping bad behavior. But there is nothing sacrosanct about the number of U.S. troops who participate in the regular fall and spring joint military exercises with South Korea. In fact, the recent exercise included only 17,500 American soldiers, a 30 percent reduction from the 25,000 who participated in the 2016 equivalent. Though Trump has steadfastly resisted Xi's call for a "freeze for freeze"—a freeze in North Korean nuclear and missile tests in exchange for a freeze in U.S./South Korean military exercises—some variant of that should be considered as part of the solution, given the alternatives. Even more enticing to China, the U.S. could offer to delay or even cancel and roll back deployment of missile defenses, including the THAAD batteries in South Korea, if China took actions that mitigated or eliminated the threat.

We recognize serious objections to each of these possible concessions and others. Indeed, we have often voiced them. But the brute fact is that, at this point, U.S. choices have shrunk to the zone between the horrific and the catastrophic. Accepting a nuclear-armed North Korea that can hold American cities hostage to a nuclear attack and attempting to live with that threat by a combination of deterrence and defenses would constitute one of the highest risks that the U.S. has faced in the seven decades of the nuclear age. Attacking North Korea to prevent that outcome will likely lead to a catastrophic second Korean War that could find thousands of Americans and Chinese killing each other.

Before choosing between these terrible options, we urge President Trump to explore a third way through candid discussions with the Chinese of options that heretofore have been "unacceptable" but that are in fact preferable to the alternatives. Kennedy and Khrushchev did. So, too, did Reagan and Gorbachev. There is no guarantee that such talks with China or the subsequent joint approach to North Korea would work – Chinese influence with North Korea may be more limited than most think – but we owe it to our security and to history to try.

If there is a better way out of the North Korea crisis, it will be through Washington and Beijing working together. For leaders determined to construct a productive U.S.-China relationship, North Korea offers a great opportunity. It also offers perhaps the greatest challenge and risk to that relationship, and therefore to U.S. leadership in the world, since the end of the Cold War.

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Mr. Chairman, I appreciate the opportunity to speak today on US policy on China. I believe it's one of the more important questions facing our country today.

I loved the serving as US Ambassador to China. One of the most rewarding jobs I've been honored to have.

I won't rehash all the relevant points in the relationship. China's amazing rise and the points of tension we are dealing with. Instead, I'll offer some suggestions.

I think it's important for Americans to be aware of what I call the American exceptionalism trap where we assume that if we keep working with another country, in this case China, American exceptionalism will prevail. They'll be more like us and differences will be manageable. It's an assumption I think we need to examine.

Although China and the US both strive to enhance the well-being of their people in profound ways our two countries are very different.

We Americans pride ourselves on our western Judeo-Christian values and democracy. On our democratic elections. Our constitution. Our bill of individual rights. Freedom of speech and press. Separation of powers where power is spread among three different branches. Our independent judiciary free from influence by the government.

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We're proud people. We're Americans. We have the world's best form of government. We've kept the peace since WWII. We lead. We help forge disputes between countries upholding our values and our approach to government. We think, no, we assume that our way is best and with patience and perseverance others will see that, too. They'll agree with us.

China has another view. China is just as proud if not more so than we Americans. After all it has had thousands of years of history. Its Middle Kingdom was the center of the universe up until the last two centuries when China was invaded and controlled by Japan, US, UK, France. Otherwise known as the two hundred years of humiliation. They now see their rightful place in world history returning.

China is authoritarian. It has one party rule. There are no elections. Very weak independent judiciary. Little free speech or rule of law. Instead, the party is everything. The party sees its role as taking care of the people. So long as they can keep people happy with rising incomes, addressing air and water pollution, food safety and health care, they believe they will indefinitely stay in power. It's the Faustian bargain that both the people and the party have upheld since they came into power in 1949. We take care of you and you don't question our legitimacy.

At the recent 19th party congress, the party strengthened its reach in virtually every area of society. China believes that a

very strong party is necessary not only to maintain control but necessary to grow and develop their country. The party is everything.

I'll never forget President Obama and President Xi explaining each country's role in November 2014. President Obama explained that human rights is absolutely fundamental to our democracy. It's in our DNA as well as our constitution. President Xi explained that the party is absolutely fundamental to their government. The party is everything and it is the duty of the party to care for the people trumping human rights.

It's not too simplistic to note that whereas we Americans believe in fairness and dispute resolution procedures enshrined in our constitution and laws, China, without those protections, is more results oriented.

While the United States tends to be ad hoc in its foreign policy decisions, China takes the long view. It has a vision. China is patient. China's One Belt One Road, it's Asian Infrastructure Investment Bank, it's Free Trade Agreements with countries it wants to do business with are all examples of China's vision to turn itself into a major of not the major economic power in the world.

This long view enables them to take small steps at a time. South China island building is reminiscent of its board game, Weiqi, taking one small step at a time so no one notices until the game is over.

China is opportunistic. They saw an opportunity when we pressed for an agreement on Climate Change, enabling them to pour immense resources into renewables such as solar and wind power at the expense of our solar and wind industries.

They saw another when Eric Snowden revealed US espionage efforts, enabling them to pass national security statues under the pretext of protecting their security interests but also allowing for discrimination against our foreign technology.

China is very different from the United States. We each have interests and different philosophies of government. Neither, at least in the indeterminate future, will persuade the other that it's better. We're different. We must understand and respect that.

So, what do we do? What should our US policy be with regard to China.

First, I urge each of you to go there. See China. Develop personal relationships. 80% of life is showing up. Load up a 747 with members of congress, the executive branch, some businessmen, NGO's and the media and fly to China. For at least two weeks. Visit as many provinces as you can. Talk to party secretaries and leaders as well as to the cab drivers. Then go back at least once a year. After a while you'll start to learn about China and develop personal relationships. You need to

see it for yourselves to properly understand the scale and magnitude of China's rise in the last 40 plus years.

I know that sounds fanciful, but if that plane were to take off I guarantee you'd see productive results.

Second, the US must develop a strategy. A strategic plan. One that defines our long-term interests. Provisions that show how we will execute it. China has a plan. We need one, too.

The plan should include US engagement not withdrawal in the region.

The most important geopolitical matter to cross my desk while I was in Beijing was the Trans Pacific Partnership. It was so important that I took it upon myself to fly to DC two months before the election to explain its importance to members of congress, both sides of the aisle and both parties.

Many SE Asian ambassadors pleaded with me to stay in the agreement so that they could play China off against the US.

Singapore icon, Li Quan Yew, personally urged president Obama to join TPP when they met in 2009 saying that otherwise the US would cede trade to China.

It was a huge mistake for the United States to pull out. Economically and geo-politically.

It's no wonder that the remaining TPP countries are going ahead without the United States.

Third, after we develop a plan, a course of action for the region the US must press its views and stand up to China when their actions are against our interests.

The Chinese understand and respect strength better than any other people I know. They can sense weakness better, too.

We did stand up and protect our interests at least several times while I served. Two involved our national security. One our economic interests.

It was with great frustration that we watched China dump sand on submerged reefs in the South China Sea converting them into features which they called islands.

During President Xi's visit to the US in March of last year President Obama in a very small group privately told President Xi that it would be a mistake for China to invade a specific South China Sea island. It worked. China didn't occupy it. We stood up.

Another time, when the US threatened sanctions on China over Chinese hacking of the Office of Personnel files, China quickly

sent over their top party national security official to negotiate a settlement with the US.

There are other examples I could mention if we had more time.

Standing up to China or having self -respect means being candid and speaking truth to power.

When I first arrived in China I would listen to the official across the table read his or her prepared talking points verbatim. The interpreter and everyone on his or her side of the table would be reading the same points.

After a few months of this formality I decided this was a waste of time. So, I interrupted him or her mid- sentence. Broke right in. Could you give me an example, or explain that more fully? I would ask. They liked it. It was more honest, more real.

I would also often ask the Thucydides Trap question. Your GDP will double in ten years, your military spending in six, I would say. The trend line shows that your economy will exceed that of the US in ten years. What are we to think? I'd ask. What are your intentions? In fact, deeds are more important than words, I'd remind them. What actions or deeds can you point to that show you want to work with US?

I thought it was important to speak truth to power. Speak honestly, directly. Not with an edge or condescension but constructively. It was the basic question that had to be asked.

They just listened. They never answered or addressed the question.

I asked it so often that soon President Xi Jinping raised it at a meeting with a cabinet secretary saying there's no trap. Later President Obama raised it with President Xi at a summit in 2015, also saying the trap isn't real.

My view is that we have to constantly keep asking that question both for China and for ourselves to better assure the trap doesn't spring shut.

That's my prescription. First, Go to China. Often. Second, develop a long range strategic plan. Third, be strong with China in the best sense of the term. Show there will be consequences if they take actions that are not in our best interest. It'll better assure that we'll find agreed upon solutions.

It's the best way to avoid the Thucydides Trap for the well-being of the peoples in both our countries.

Statement to U.S. Senate Subcommittee on East Asia, the Pacific, and International Cybersecurity Policy

"American Leadership in the Asia-Pacific, Part 4: The View from Beijing"

Tuesday, November 14,

Dr. Michael Pillsbury
Senior Fellow and Director, Center for Chinese Strategy
The Hudson Institute
Washington, D.C.

Chairman Gardner and Ranking Member Markey,

Thank you for the opportunity to testify in your series of hearings on American leadership in the Asia Pacific. I understand today's subject is Part 4, "The View from Beijing." Your letter of invitation raised seven specific questions. When I was a Senate staffer for the Budget Committee, the Labor and Human Resources Committee and the Foreign Relations Committee, I noticed Senators appreciated not only short answers but also information that would be relevant to legislation or possible initiatives. In that spirit, I address your seven questions first, then I want to provide you with some background reading that supports my answers, not for today but for your next long flight overseas – a new view of the declassified evidence of "how we got here" in terms of today's US-China relationship. My thesis in The Hundred-Year Marathon is while Americans have the illusion we have been managing China's rise, the truth is the other way around - China has been doing a much better job of managing America's decline. I agree with both Henry Kissinger and Professor Graham Allison's effusive praise of the assessment of China by former Singapore Prime Minister Lee Kuan Yew. Allison wrote, "The rise of China is the issue about which Lee undoubtedly knows more than any other outside observer or analyst." However, both Allison and Kissinger do not pay sufficient attention in my view to the implications for us of Lee Kuan Yew's most important finding. Lee wrote, "It is China's intention to be the greatest power in the world...." Of course, we should never overestimate China's power or ability to surpass us, but more and more of allies are saying quietly, "that the way to bet." My book advocates 12 steps for a new strategy toward China, which I will not elaborate today. I have read the testimony of your three prior hearings and largely agree with your earlier witnesses on both the economic side and the security issues. As well, Chairman Corker held an insightful hearing on how to improve security cooperation with both General Charles Hooper, head of DSCA and a mandarin-speaker who served twice in Beijing, as well as State Department witnesses on the difficulty of coordinating State and Defense when so many senior positions are still vacant.

Your first four questions concern China's intentions in the Asia Pacific, what is President Xi Jinping's vision, what are the main takeaways from the recent 19th Party Congress, and how does the Chinese leadership view the United States and its role in the region.

The answer to all four questions is, in one word, "continuity." China's leaders are continuing to implement a largely secret set of policy decisions made about 40 years ago. The Chinese leadership abandoned its earlier strategies of first allying with the Soviet Union in the 1950s and then going it alone in the 1960s. Some of their policy ideas were uniquely Chinese, especially about the slow pace they would follow, and others were derived from their deep relationship with the World Bank beginning in the 1970s. In the 1980s, the World Bank opened its largest office in the world in Beijing. China's leaders sought and followed advice from World Bank and IMF officials, and from many Nobel prize winners in economics, and even from Goldman Sachs, as told in detail in former Treasury Secretary Hank Paulson's book *Dealing with China: An Insider Unmasks the New Economic Superpower*. They set up a national policy which has been correctly labeled mercantilist and even predatory. Many have criticized them, and an innovative report from ITIF called the *World Mercantilist Index* has consistently scored China to be Number One. China's response has been ignoring this criticism and to imply that reforms are coming – someday. Some Chinese authors cite American history in the century from 1820 to 1920 as their model for government-assisted growth through these predatory practices.

Your second set of three questions focuses on US policy, asking specifically how US-China policy should take into account China's intentions, whether the Obama Administration's Asia pivot or rebalance policy succeeded in deterring Chinese destabilizing activities, what policy the Trump Administration should pursue to improve US policy toward the Asia Pacific and China, and how to assess President Trump's recent visit to the region. I thought the President's Asia trip was a success, particularly in its focus on multi-lateral and alliance relationships with ASEAN, APEC and our military allies in Japan, South Korea and the Philippines. He laid an excellent foundation for his future visits to the region.

I would also answer your three questions about US policy with just one word, "innovation." My own advice to the Trump Administration as a transition adviser has been simple. We need a holistic approach led by the President himself who alone can coordinate the Defense Department, USTR, Commerce, Treasury, and important elements in the State Department in designing new strategies to deal with the issues of trade, security cooperation, and multilateral coordination.

In my view, it is way too soon to judge whether the Trump Administration will have the leverage to significantly change Chinese predatory practices, a concern that has been publicly raised by USTR Ambassador Bob Lighthizer. My view has been that we need to press the Chinese toward reforms by working with our allies, not alone. We also need to be aware of our allies inside China who have been frustrated or even punished for their advocacy of real reforms. Cato Institute has honored an economic reformer named Mao Yushi, but it was not widely reported. Too few know the specific reforms advocated by the late Liu Xiaobo whose writings were made available in a book by Professor Andy Nathan of Columbia.

There are specific policy areas where a holistic strategy should be designed. I recommend that the State Department take the lead in advising the President on how to coordinate the

timing and implementation of all the components that a new strategy for the Indo-Pacific will need. Many do not include all these components, and many areas too often go uncoordinated such as the democracy promotion funds at USAID and State, and the Asia program of the National Endowment for Democracy. Pacific Command is not just a DoD combatant command, but often offers ideas in overall strategy, civil aspects of security cooperation, and the rule of law.

In the long term, one of first challenges is Congress should require the State Department's Bureau of Intelligence and Research [together with the entire IC and DoD] to present to the Congress a genuine assessment of the US-China military balance, [to include future technology issues]. An outline of how to assess this balance has been suggested in an alarming Rand report called *The US-China Military Scorecard, 1996-2017*. The current annual DoD report to Congress that has been required since 2000 under the NDAA does not directly compare the military "scorecard" of the US and China, yet many textbooks teach us that the underlying military balance has a decisive impact on our diplomacy and on deterrence.

We do not want our allies to doubt that the Indo-Pacific military balance favors us in the long term. Andy Marshall at the DoD Office of Net Assessment studied this issue at the initial direction of Henry Kissinger in 1973. One of his findings was that perceptions of a declining military balance can be as important as a real decline. We took many initiatives based on Andy Marshall's insights largely about the Soviet Union. Congress needs to request similar studies of the future military and technological balance with China. The trend may be against us if the forecasts are correct Chinese economic growth in PPP has already surpassed us.

The second set of State-Department led policies must include specific steps in the fields of trade and technology protection that fall to many different departments and agencies:

1] more lawsuits at the WTO,

2] comprehensive CFIUS reform,

3] a mechanism through which we can coordinate restrictions on Chinese investment with our European allies, and

4] a large increase in federally funded R&D to return to the level of three decades ago,

5] publishing a list of Chinese companies engaged in IP theft and unfair trade practices to inform potential litigants to of possible legal targets,

6] measures to provide US companies and US government regulators a better understanding of Chinese state-owned entities in the US,

7] amendment of the Foreign Sovereign Immunities Act to and the Economic Espionage Act to protect ourselves, and

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8] developing comprehensive responses [particularly with India] to China's Belt and Road Initiative and [with the European Union] to the new "Made in China 2025" plan.

9] an inventory of the official programs and activities we undertake to assist China's growth.

10] intelligence efforts reduce industrial espionage and cyber theft.

All of these steps face a challenge. Americans tend to assume falsely that we have been in charge of relations with an essentially benign and economically inferior China. One of the great lessons of history Americans have been taught over the years is that President Richard Nixon and Henry Kissinger took a brilliant strategic initiative to "open" a backward, internally-focused China. But what if China has been more successful in taking initiatives against us – from the start?

In a little-noticed sentence in his book *On China* published in 2011, Dr. Kissinger has correctly changed the dramatic narrative of a unilateral American diplomatic initiative. Instead, he revealed new Chinese materials and admitted there was a "parallel" effort inside China to "open" America. Indeed, he lists five times when he and Nixon actually turned down the earliest Chinese initiatives. My book *The Hundred-Year Marathon* presents even more evidence. I was permitted by the CIA, the FBI and the Defense Department to use both new American declassified documents and new Chinese materials to show that the foundation of US-China relations is very different from what has been taught in earlier historical accounts. This new history has been well-received – *The Hundred-Year Marathon* was a # 1 national best seller and translated into Japanese, Korean, and two different Chinese editions in both Taiwan and China. One reaction to this newly history is that the prospects for future US-Chinese cooperation are much greater than most had assumed. Conversely, the prospects for a US-China war are more remote. Strangely, there are at least six American or British books about the growing likelihood of an American war with China. There are none about the likelihood of a "G-2" style era of strategic cooperating with China. The books are all useful, with dramatic titles like *The Coming Conflict With China, The Coming China Wars, The Next Great War, China's Coming War with Asia*, and my personal favorite by Graham Allison, *Destined For War: Can America and China Escape the Thucydides Trap?*

My own view is that President Trump is on the right track to pursue strategic cooperation with China. He has even acknowledged in his own books and speeches a deep admiration for how smart Chinese strategy has been.

But the problem of complacency threatens us. Too many believe China will not be a challenge because it will collapse long before surpassing us. Others claim we have been in charge of China since 1969 and that China has no strategy, but is merely muddling through. Is this true?

How Did We Get Here? *The Hundred-Year Marathon since 1969*:

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Nixon and Kissinger have admitted that in their first months in office, their focus was on improving relations with the Soviet Union. They had no desire to provoke the Soviets' ire by dallying with China. Indeed, in many ways, it was not Nixon who went to China, but China that went to Nixon. In the case of each American president, Beijing's strategy seems to have been a product of brilliant improvisation—constant tactical shifts combined with shrewd assessments of the internal differences among the main players in Washington debates. In their assessment of shi vis-à-vis the United States, China's leaders benefited from something considered to be of critical importance during the Warring States period: a well-placed spy in the enemy's ranks.

A forty-year employee of the CIA, Larry Wu-Tai Chin, was accused in 1985 of engaging in decades of espionage on behalf of China. Chin was accused of providing countless classified U.S. documents regarding China to the Chinese government, charges to which Chin pled guilty in 1986. While confessing to a judge, Chin declared that he acted as he did to promote reconciliation between the United States and China. Shortly thereafter, he was found by a guard asphyxiated in his prison cell. Larry Chin seemed to admit to the judge he revealed our planning and weaknesses to the Chinese government so Beijing could have been highly effective in getting all it wanted.1

America, in contrast, has not had similarly placed informants to provide direct insight into Chinese strategic thinking. Because we also lack access to internal Chinese policy documents, this chapter attempts to unearth the motivations of China's leaders during the time of renewed relations with the United States through the end of the Reagan administration by examining U.S. accounts of what appeared to be driving China, as well as another open-source information that has emerged since.

Unlike the United States, China has not released, nor is it likely to ever release, official internal records showing how Chinese leaders were able to obtain essentially all of the major economic, military, and diplomatic-political assistance it sought from the last eight U.S. presidents, from Richard Nixon through Barack Obama. However, there do appear to be consistent strategic approaches followed by Beijing that have been acknowledged in general terms in interviews of and articles by Chinese scholars. The nine elements of Chinese strategy (introduced in chapter 2) help us to better make sense of China's past and prospective actions. The use of deception, shi, patience, and avoiding encirclement by the Soviet Union are all apparent. In particular, the nine key elements of Chinese strategy have guided China throughout its decades-long campaign to obtain support from the United States to increase China's strength.

There is wide agreement that in the late 1960s, with their outsize ambitions exposed to the Soviets, with whom they were on the brink of military confrontation, China sought out a new benefactor. For ideas about how to make America a friend—or, to be more precise, a temporary ally—Mao turned to the military rather than to his diplomats.

Many Americans discounted the influence of China's hawks. They were surprised to learn that the military secretly designed China's opening to America. In the spring of 1969, Mao

summoned four hawkish army marshals who wanted to end China's decade of passivity and instead to stand up to the threat of the Soviet Union—Chen Yi, Nie Rongzhen, Xu Xiangqian, and Ye Jianying.2 These marshals summed up the American strategy toward the Soviet Union and China in a Chinese proverb of "sitting on top of the mountain to watch a fight between two tigers."3 In other words, they believed America was waiting for one Communist country to devour the other, and they thought in terms of ancient lessons from the Warring States period.

In May 1969, Mao asked them for further recommendations. According to Kissinger, the marshals' private secretary recorded that the group discussed "whether, from a strategic perspective, China should play the American card in case of a large-scale Soviet attack on China."4 Marshal Chen Yi suggested that the group study the example of Stalin's nonaggression pact with Hitler in 1939.

Another marshal, Ye Jianying, cited the "Red Cliff strategy" pursued by Zhuge Liang, the southern commandeer who outwitted Cao Cao: "We can consult the example of Zhuge Liang's strategic guiding principle, when the three states of Wei, Shu, and Wu confronted each other: 'Ally with Wu in the east to oppose Wei in the north.'"5 In the marshals' view, America feared a Soviet conquest of China: "The last thing the U.S. imperialists are willing to see is a victory by the Soviet revisionists in a Sino-Soviet war, as this would [allow the Soviets] to build up a big empire more powerful than the American empire in resources and manpower."6

Chen Yi pointed out that the new president, Richard Nixon, seemed eager "to win over China." He proposed what he called "wild ideas" to elevate the United States–China dialogue to the ministerial level, or even higher.7 Most revolutionary, according to Kissinger, was Chen Yi's proposal that the People's Republic drop its long-held precondition that Taiwan be returned to mainland China.8

Foreign Minister [and retired general] Chen Yi argued:

"First, when the meetings in Warsaw [the ambassadorial talks] are resumed, we may take the initiative in proposing to hold Sino-American talks at the ministerial or even higher levels, so that basic and related problems in Sino-American relations can be solved....

Second, a Sino-American meeting at higher levels holds strategic significance. We should not raise any prerequisite.... The Taiwan question can be gradually solved by talks at higher levels. Furthermore, we may discuss with the Americans other questions of strategic significance."9

China still called the United States its enemy, describing a possible visit by Nixon as an instance of China "utilizing contradictions, dividing up enemies, and enhancing ourselves."10 In other words, the United States was merely a useful tool for China, not a long-term ally. Operating on this principle, Beijing sent a secret message to Nixon and Kissinger: since President Nixon had already visited Belgrade and Bucharest—capitals of other Communist countries—he would also be welcome in Beijing.11 The message contained no hint of trust or future cooperation.

China has not released internal documents to substantiate the reasons for the decision to reach out to America, but several Chinese generals have told me that Mao's subtle approach to the Nixon administration was a striking example of identifying and harnessing shi, with some telling me that there was one moment that caused Mao to redouble his efforts: a major battle at the border of Xinjiang in northwestern China on August 28, 1969. Beijing mobilized Chinese military units along China's borders. By then, Kissinger concludes, resuming contact with the United States had become a "strategic necessity." At the United Nations in New York, I heard the Soviet version of their attack and quickly passed it to Peter and Agent Smith to inform the contentious NSC debate about the risks of reaching out to China.

In 1969, Mao was able to assess correctly the shi that was driving China out of the Soviet orbit and toward a new alliance with the West. Mao had taken two actions to accelerate this shift. The first was his invitation of Nixon to Beijing. The second was to test two massive hydrogen bombs without warning within days of each other near the Soviet border. The act served both as a show of force and as a signal to America that China sought to move away from the Soviet orbit.

Realizing the Americans still weren't quite getting the message, Mao did something on October 1, 1970, quite unusual for the committed and anti-Western Communist: he invited the well-known American journalist and author Edgar Snow to stand with him on the Tiananmen reviewing stage, and arranged for a photograph of both of them to be taken for all of China to see. Mao gave his guest a message: President Nixon was welcome to visit China. This was an astonishing invitation—the latest of several overtures by the Chinese government. Kissinger admits that Washington still did not get the message, or at the very least did not appreciate its sincerity. The U.S. government was too preoccupied with its own interests and strategies to care about China's. Thus the history of normalized Sino-American relations started off with a myth. Nixon did not first reach out to China; instead, China, in the person of Mao, first reached out to Nixon. The Americans just didn't realize it. Nor did Washington yet know that Chinese documents called America the enemy and likened it to Hitler.

As Nixon and Kissinger considered their grand strategic approach to China, I was playing a much smaller role in this drama. In the autumn of 1969, my interlocutors within the intelligence agencies, Peter and Agent Smith, requested that I brief Kissinger's staff about the information I had gathered while working as an intelligence asset at the United Nations. In my meetings with Kissinger's top advisers, I detected a sharp split on China. Two National Security Council staffers, John Holdridge and Helmut Sonnenfeldt, wrote memos that seemed to favor an overture, with neither fearing a Soviet overreaction.12 But two others, Roger Morris and Bill Hyland, were opposed.13 Morris and Hyland feared that any U.S.-China alliance would needlessly provoke Moscow and severely damage the administration's emerging policy of détente with the Soviet Union. Four senior American ambassadors had already met in person with Nixon to warn him that Moscow would respond to any U.S. opening to China by halting movement toward détente and arms control. These clashing memos help to explain why Nixon and Kissinger delayed the opening to China by two years. They had to be prodded by China, and

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by my own reports from the Soviets at the United Nations that Moscow would not call off détente and actually expected America to accept China's deceptive offers of an alignment. Shevchenko and Kutovoy had said exactly this to me.

My evidence seemed to play a modest role in breaking this deadlock. I relayed what I had gathered so far: that the Sino-Soviet split was in fact genuine and that the Soviets expected us to open relations with the Chinese. I reported, and others verified, that senior diplomats such as Arkady Shevchenko already assumed that Nixon would improve relations with China to some degree. Their fear was only that he would go "too far" and establish military ties—something that was not then on the table. I was a strong—and, I hoped, persuasive—advocate for a Sino-American alliance. Kissinger even sent me a thank-you note later.

But there were additional factors at work that persuaded Kissinger and ultimately President Nixon to move toward Beijing. While Kissinger was still attempting to discern Chinese intentions, Senator Ted Kennedy was seeking to visit China. The Chinese even mentioned this possibility to Kissinger during his secret trip to Beijing in July 1971, consistent with Warring States concepts about manipulating hawks and doves. Nixon reacted as anticipated and instructed Kissinger to ask the Chinese to invite no other U.S. political figure to visit China before Nixon. Nixon believed, with good reason, that Kennedy was attempting to steal his thunder and become the first American politician to travel to Beijing.14 Raising the possibility in public speeches of renewed relations with Communist China, Kennedy was putting together what looked to be a foreign policy platform for the 1972 presidential election.15

Another factor was China's involvement in the Vietnam War. Beginning in the 1950s, China had been supplying North Vietnam with weapons, supplies, and military advice. China had recently reduced military aid to North Vietnam and had even drastically reduced Soviet shipments through China, which further persuaded the Nixon administration to side with the pro-China camp.

The Americans would receive reassurance on this front during Nixon's visit to Beijing when Mao told the president that he was eager to remove any threat from China to the United States: "At the present time, the question of aggression from the United States or aggression from China is relatively small; that is, it could be said that this is not a major issue, because the present situation is one in which a state of war does not exist between our two countries. You want to withdraw some of your troops back on your soil; ours do not go abroad."16

Kissinger asserts that this sentence indicating that Chinese troops would not go abroad reduced the U.S. concern that China would intervene in Vietnam, as it had done in Korea in 1950.17 Mao correctly recognized that this fear featured prominently in American thinking and wanted to induce complacency.

In July 1971, Kissinger made his historic secret visit to China, the first tangible realization of Mao's long-held plans. The Chinese were coy about the Soviet threat that had driven them to

reach out to the Americans. Foreign Minister Zhou Enlai referred only obliquely to "our northern neighbor" and "the other superpower." Nor did the Chinese side initiate any further discussion on the issue of the Soviet threat.18 Were they really so terrified of an attack?

During Kissinger's subsequent trip to Beijing, in October, Zhou placed the Soviet Union on a list of six key issues on the substantive agenda, although he listed it last. After the Chinese declared that they were not opposed to improvements in American-Soviet relations, Kissinger concluded that they were displaying bravado and concealing their fear of the Soviet threat.19 Kissinger warned Zhou of Moscow's "desire to free itself in Europe so it can concentrate on other areas."20 "Other areas" meant the People's Republic of China.

But there were glimpses even then that the Chinese saw the United States not as an ally but as an obstacle. Referring to the United States, Zhou offered a hint of how the Chinese really felt about their new prospective friend.

"America is the ba," Zhou told Kissinger's interpreter, Ambassador Ji Zhaozhu of China's Foreign Ministry, repeating a term that would be frequently used by Chairman Mao and his successor, Deng Xiaoping.

U.S. government officials who understand Mandarin—a small but growing group—have long known that many Chinese and English terms cannot be fully translated between the two languages. Choices must often be made by the interpreters about what each side really means. Kissinger's translator told Kissinger that Zhou's statement meant, "America is the leader." This seemed to be an innocuous remark, and when taken in the context of the Cold War even a compliment. But that is not what the word ba means in Mandarin—at least that is not its full context.

Ba has a specific historical meaning from China's Warring States period, where the ba provided military order to the known world and used force to wipe out its rivals, until the ba itself was brought down by force. The ba is more accurately translated as "tyrant." In the Warring States period, there were at least five different ba. They rose and fell, as each new national challenger outfoxed the old ba in a contest of wits lasting decades or even a hundred years. One wonders how U.S. policy toward China might have shifted had Kissinger been told that day that the Chinese saw Americans not as leaders, but as wrongdoers and tyrants. To this day we still have to sort out and live with the consequences of that key mistranslation.

Some years later, I had the privilege of talking to Ambassador Ji Chaozhu. He omitted any discussion of how he translated the concept of ba to Kissinger in his otherwise chatty memoir The Man on Mao's Right, which provides a rare insider's account of how China's Foreign Ministry viewed the opening to the United States. I asked if the word "leader" he used in English had originally been the Chinese word ba.

"Did you tell Dr. Kissinger what a ba was?" I asked.
"No," he replied.

"Why?"
"It would have upset him."

If Kissinger had realized what Zhou meant by ba—if he had realized how China really viewed the United States—the Nixon administration might not have been so generous with China. Instead, the administration soon made numerous offers of covert military assistance to China21—all based on the false assumption that it was building a permanent, cooperative relationship with China, rather than being united for only a few years by the flux of shi. Perhaps if U.S. analysts had gained access to views of the anti-American hawks, China's perception of America as a tyrannical ba would have alerted Washington. A RAND study in 1977 warned of evidence since 1968 that there was a strong anti-American group within the Chinese leadership that used proverbs such as America can "never put down a butcher's knife and turn into a Buddha."22

Two months after Zhou's conversation with Kissinger, with Nixon's visit just around the corner, Kissinger made the first of many covert offers to the Chinese. Unbeknownst to a public that would have been shocked to see the United States aiding and abetting the People's Liberation Army, Kissinger gave China detailed classified information about Indian troop movements against Pakistan,23 as well as America's "approval of Chinese support for Pakistan, including diversionary troop movements."24 In return, Kissinger asked for Chinese troop movements on the Indian border to distract India from its efforts to invade and then dismember eastern Pakistan. China's troops did not move, but that did not dampen American expectations.

In January 1972, Nixon authorized Kissinger's deputy Alexander Haig to make another covert offer to China. Heading an advance team to China just a month before Nixon's historic visit, Haig promised substantial cooperation with China against the Soviet Union. Haig told Zhou that during the crisis between India and Pakistan, the United States would attempt to "neutralize" Soviet threats along China's borders and "deter threats against [China]." As far as covert deals go, these first two offers by Kissinger and Haig were tactical. But they represented a sharp turn after two decades of a complete American embargo on China. And, most significantly, they were a sign of larger offers to come.

China played its role to perfection once Mao sat face-to-face with Nixon in February 1972. Mao assumed the same role with the Americans that he had early on with the Soviets—portraying China as a harmless, vulnerable supplicant desperate for aid and protection. "They are concerned about me?" Mao once asked, referring to the Americans. "That is like the cat weeping over the dead mouse!"25 Mao even put the Americans on the defensive by claiming that they were standing on China's shoulders to get at Moscow.

Years later, Kissinger reflected on the palpable uncertainty he perceived when coordinating with Chinese officials: Was America's commitment to "anti-hegemony" a ruse, and once China let its guard down, would Washington and Moscow collude in Beijing's destruction? Was the West deceiving China, or was the West deceiving itself? In either case, the practical consequence could be to push the "ill waters of the Soviet Union" eastward toward China.26 To

counter these possible perceptions, Nixon promised Mao that the United States would oppose any Soviet "aggressive action" against China.27 He stated that if China "took measures to protect its security," his administration would "oppose any effort of others to interfere with the PRC."28

On the same day Nixon met other leaders in Beijing, Kissinger briefed Marshal Ye Jianying, the vice chairman of the military commission, and Qiao Guanhua, the vice minister of foreign affairs, about the deployment of Soviet forces along the Sino-Soviet border. As Yale Professor Paul Bracken first pointed out in a 2012 book, The Second Nuclear Age, China was given nuclear targeting information in the briefing, which Marshal Ye considered "an indication of your wish to improve our relationship."29 Discussion during the briefing included details about Soviet ground forces, aircraft, missiles, and nuclear forces.30 Winston Lord, Kissinger's key aide on China, knew that the White House assumed that the Soviets might well "get to hear of" this exchange of information.31 Indeed, Moscow soon did.32

Mao asserted that the United States and China should cooperate in dealing with the Soviet "bastard" and urged that Washington should work more closely with its allies, particularly to maintain NATO unity.33 Mao also urged the United States to create an anti-Soviet axis that would include Europe, Turkey, Iran, Pakistan, and Japan.34 A counter-encirclement of the Soviet hegemon was a classic Warring States approach. What the Americans missed was that it was not a permanent Chinese policy preference, but only expedient cooperation among two Warring States. Mao's calculations in 1972 were not clarified until the Chinese released a memoir two decades later.35

This played well with Kissinger, who told Nixon "with the exception of the UK, the PRC might well be the closest to us in its global perceptions."36 There seemed to be little suspicion of China's strategy.

Yet the Chinese remained suspicious of the United States. They did not share Kissinger's view that the Shanghai Communiqué, the document of understanding that was signed at the end of the summit, suggested that "a tacit alliance to block Soviet expansionism in Asia was coming into being."37 The communiqué stated: "Neither [the United States nor China] should seek hegemony in the Asia-Pacific region, and each is opposed to efforts by any other country or group of countries to establish such hegemony; and neither is prepared to negotiate on behalf of any third party or to enter into agreements or understandings with the other directed at other states.

If the Nixon administration wanted a quasi alliance with China, China's message seemed to be that the Americans needed to offer more. Thus the Nixon administration's next covert offer of support came in a February 1973 meeting in Beijing. It also included an explicit security promise, based on finding a way that the United States and China could cooperate that would at best deter Moscow and at least get the Soviets' attention. Kissinger told the Chinese that Nixon wanted "enough of a relationship with [China] so that it is plausible that an attack on [China] involves a substantial American interest."38 This is the concept of a symbolic trip wire,

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as used in U.S. troop deployments in South Korea and previously in West Germany to demonstrate that the United States has a "substantial national interest" in a given contingency. Kissinger was not promising a permanent deployment of U.S. troops to China's northern border, but he wanted something that would make a splash. This is what Mao's generals had proposed he seek from Nixon in 1969: a conspicuous gesture to Moscow.

Kissinger even provided a timeline for this strategy. "The period of greatest danger" for China, he told Huang Hua, China's ambassador to the United Nations, would be in the period from 1974 to 1976, when the Soviet Union would have completed the "pacification" of the West through détente and disarmament, the shifting of its military forces, and the development of its offensive nuclear capabilities. Kissinger wanted the trip wire in place by then.

The next covert offer—the fourth since Nixon's first meeting with Mao and the sixth since Kissinger's first trip to China—promised to offer China any deal America offered to the Soviet Union. In the run-up to the summit meeting between Nixon and Soviet leader Leonid Brezhnev in June 1973, Kissinger reaffirmed that "anything we are prepared to do with the Soviet Union, we are prepared to do with the People's Republic."39 In fact, the United States was willing to offer China deals even better than those made with the Soviets: "We may be prepared," said Kissinger, "to do things with the People's Republic that we are not prepared to do with the Soviet Union."40

At about this time, Nixon sent a note stating "in no case will the United States participate in a joint move together with the Soviet Union under [the Prevention of Nuclear War] agreement with respect to conflicts ... where the PRC is a party."41 At the same time, he decided to circumvent U.S. law and regulations by providing technology to China through the British.42

The seventh covert offer was the most sensitive one, and would not be revealed for three decades, even to the CIA. It grew out of an internal debate I witnessed in October 1973 about whether to back up America's vague promises to Beijing and do something tangible to strengthen China, or to stay at the level of mere words and gestures. The United States could establish a "more concrete security understanding" with the Chinese, or instead merely promise significant progress in the diplomatic normalization of bilateral relations.43 There was a strong case for each option.

That year, I was working at the RAND Corporation, where as a China expert I had been given top-secret access to Kissinger's conversations with Chinese leaders by Richard Moorsteen, a RAND colleague close to Kissinger. Andy Marshall and Fred Iklé had hired me at RAND, the latter of whom soon left RAND after Nixon appointed him director of the Arms Control and Disarmament Agency. Iklé invited me to see him at his agency's offices several times in 1973 to discuss my analysis of China, and to draft a proposal to Kissinger of secret cooperation of intelligence and warning technology.

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I shared Iklé's support for tangible U.S. covert cooperation with China. Though Iklé told Kissinger that a "formal relationship" (that is, a formal alliance) was not desirable, Washington could unilaterally provide help of a "technical nature." The United States could set up a "hotline" arrangement that would provide a cover for Washington to give Beijing secret early-warning information about Soviet military actions directed against China. "Given that a large portion of the Chinese strategic forces will continue to consist of bombers, hours of advance warning could be used by them to reduce the vulnerability of their forces significantly," Iklé and I wrote in one memo. "The fact that the hotline might enable us to transmit warning of a possible Soviet attack could be a powerful argument." We also advocated Washington's selling to Beijing hardware and technology to alert the Chinese if the Soviets were about to attack, and we supported providing America's superior high-resolution satellite images to heighten the accuracy of Chinese targeting of Soviet sites.44 Kissinger agreed with our proposal. Only a few knew that he proposed tangible U.S. covert cooperation with China. On a trip to Beijing in November 1973, Kissinger told the Chinese that in the event of a Soviet attack the United States could supply "equipment and other services." America, Kissinger said, could help improve communications between Beijing and the various Chinese bomber bases "under some guise." He also offered to provide the technology for "certain kinds of radars" that the Chinese could build.45 In other words, Kissinger secretly offered aid to the People's Liberation Army. He was proposing the beginnings of a military supply relationship, both in peacetime and in the event of a Soviet attack.

To my surprise, the Chinese initially balked at the seventh offer, asking for time to study the proposals before responding further.46 They said that American cooperation with early warning would be "intelligence of great assistance," but this had to be done in a manner "so that no one feels we are allies." With a mentality straight out of the Warring States era of ruthlessness and shifting alliances, China's leaders were suspicious that Kissinger's offer was an attempt to embroil China in a war with Moscow.

The Chinese perhaps did not recognize the risk Nixon and Kissinger had taken to make this offer. Kissinger's closet adviser on China, Winston Lord, had argued strongly against this step in a memo to Kissinger, saying that it would potentially be unconstitutional (not to mention widely opposed) and would inflame the Russians. Kissinger had overruled Lord's objections, though Lord himself was a strong supporter of improving relations with China.

Sino-American relations went through their biggest improvement in the late 1970s, as Deng Xiaoping took on increasing power and became the public face for China's PR offensive with the United States. To Westerners, Deng was the ideal Chinese leader: a moderate, reform-minded man with a tranquil, grandfatherly demeanor. He was, in short, the kind of figure Westerners wanted to see.

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But Deng was no docile grandfather. In private meetings within the Politburo, he raged at aides and advisers over China's lack of progress against the West. He believed that under Mao and his questionable "reform" practices, China had lost thirty years in its campaign to surpass the American ba.

Deng was enthusiastic about a partnership with the Americans, but for a key reason not meant for public consumption. He had rightly deduced that by following the Soviet economic model, China had backed the wrong horse and was now paying the price. Internal Chinese documents, which came into the hands of U.S. intelligence officials long after the fact, showed that Chinese leaders concluded that they had failed to extract all they could from their now-faltering Soviet alliance. Deng would not make the same mistake with the Americans. He saw that the real way for China to make progress in the Marathon was to obtain knowledge and skills from the United States. In other words, China would come from behind and win the Marathon by stealthily drawing most of its energy from the complacent American front-runner.

Within the Politburo, Deng was known for referencing a favorite admonition from the Warring States, tao guang yang hui (hide your ambitions and build your capability). Deng, too, sent opponents messages through seemingly oblique and harmless stories. During his first meeting with President Gerald Ford in December 1975, he referred to a story from the classic Chinese book The Romance of the Three Kingdoms to make what in retrospect was an important point, one completely lost on Ford. The story again involves Cao Cao, discussed in the previous chapter, considered in Chinese literature to be one of history's greatest tyrants. Cao Cao, in fact, probably best exemplifies the concept of a ba in ancient Chinese literature.

In the particular vignette Deng told Ford, Cao Cao defeats Liu Bei, a rival challenger, and remains the ba. After their war, the challenger offers to work for Cao Cao, but Cao Cao remains suspicious of Liu Bei's loyalty. Deng cited to President Ford Cao Cao's famous quote "Liu Bei is like an eagle, which when it is hungry will work for you, but when it is well fed, will fly away." Ostensibly, the "eagle" in Deng's story was the Soviet Union. American attempts to accommodate the Soviets, Deng warned, would fail. Once they had what they wanted, the Soviets, like Liu Bei, would pursue their own interests. What the Americans missed from that anecdote was that the same strategic sentiment held true for China. Once America built China into an equal, China would not remain an ally but would "fly away."

However, Deng tactfully decided not to tell the most famous story about Cao Cao and Liu Bei—for if he had done so, he would have divulged China's true aims in dealing with the Americans. Chinese hawks had not yet begun to write openly about the allegory contained in these ancient stories. We would need this key to decode Chinese strategic allusions. There was no sign that either Ford or Kissinger had any idea what Deng was talking about.

Entranced as they were by their new relationship with the Chinese, the Nixon and Ford administrations willingly satisfied many of China's immediate political objectives.

All these gifts—and more to come—were kept secret from the American public for at least thirty years. The United States not only cut off the CIA's clandestine assistance program to the Dalai Lama—Public Enemy Number One to Communist China—but also canceled the U.S. Navy's routine patrols through the Taiwan Strait, which had symbolized America's commitment to Taiwan.48 American policy became a series of initiatives to strengthen China against its adversaries.

In 1975, while still at RAND, I wrote an article for Foreign Policy magazine advocating military ties between the United States and China, to create a wedge against the Soviets. Richard Holbrooke, the once and future diplomat, was then serving as the magazine's editor. He was a strong proponent of the article, labeling my idea a "blockbuster." He shared my thoughts with other editors, leading to a long story in Newsweek, "Guns for Peking?" Other media outlets picked up the proposal, while the Soviet press attacked both the arguments I made in the proposal and me personally.49 Chinese military officers at the United Nations had suggested the idea to me. So in 1973 I began four decades of conversations with China's military hawks, hearing about lessons from Warring States to deal with the hegemon, which I then assumed would always mean the Soviet Union.

In early 1976, Ronald Reagan, running against President Ford for the Republican presidential nomination, read the article. (I had sent it to Reagan at Holbrooke's behest.) In a handwritten note, the former California governor said he agreed with the idea of closer ties with the Chinese as a wedge against the Soviets. But he also cautioned me about the Chinese, and worried in particular about abandoning America's democratic allies in Taiwan. After I met with Governor Reagan at his Pacific Palisades home—where he joked about being "sixty-four years old and unemployed"—he encouraged me to keep sending him material about China that he might use in speeches.

In 1978, relations with the United States moved toward normalization—that is, official American recognition of Communist China as the legitimate government of the Chinese people. That year, Deng focused immediately on what was at the top of his American wish list: science and technology. This was an example of the Warring States concept known as wu wei—or, having others do your work.50 As he formulated a strategy in 1978, Deng understood, as he put it, that "technology is the number one productive force" for economic growth.51 The only way China could pass the United States as an economic power, Deng believed, was through massive scientific and technological development. An essential shortcut would be to take what the Americans already had. Deng found a willing partner in that effort in a new American president, Jimmy Carter, who was eager to achieve the diplomatic coup of a formal Sino-American partnership.

In July 1978, President Carter sent to China the highest-level delegation of U.S. scientists ever to visit another country. Frank Press, Carter's science adviser and a former MIT professor specializing in earthquake science, led the delegation. Press had been chairman of the U.S. Committee on Scholarly Communication with the People's Republic of China from 1975 to 1977, and therefore took particular interest in scholarly exchanges with China. The Press

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delegation received great attention from the Chinese. The People's Daily rarely published speeches by foreigners, but in this case it printed Press's banquet speech, which stressed the advantages of globalization. And Michel Oksenberg, a National Security Council official for China policy who would sit in on some fourteen meetings with Deng, said he never saw Deng more intellectually curious and more involved in articulating his vision about China's future than on this trip. Again playing the role of vulnerable supplicant, Deng spoke to Press's delegation about China's all but hopeless backwardness in science and technology and expressed his concerns about American constraints on high-tech exports to his country. In the past, Beijing kept tight control over the country's scientists going to the United States, limiting their numbers in fear that the scientists might defect. Press expected that they would likewise be cautious about expanding scientific exchanges with the West. So he was surprised when Deng proposed that the United States immediately accept seven hundred Chinese science students, with the larger goal of accepting tens of thousands more over the next few years. Deng was so intent on receiving a prompt answer that Press, considering this one of the most important breakthroughs in his career, telephoned President Carter, waking him at 3:00 a.m.

Like his adviser, Carter gave little thought to the implications of China's sudden intense interest in scientific exchanges, viewing it as merely a welcome sign of improved relations. In January 1979, Deng made his first and only visit to the United States, and he was a hit. President Carter feted him at a state dinner and, in a sign of the bipartisan flavor of U.S.-China policy, even invited the disgraced Richard Nixon to attend, the first time the former president had visited the White House since his resignation in August 1974. Deng spent thirteen days in the United States, touring Coca-Cola's headquarters, the Johnson Space Center in Houston, and even *Disney World. In a sign of acceptance by the American popular media, Time magazine put Deng* on its cover, twice. At the National Museum in Beijing, one can see displayed a photograph of Deng smiling beneath a ten-gallon hat he received in Texas, which became the symbol of his 1979 visit. It signaled to the U.S. public that he was good-humored, less like one of "those Communists" and more like "us." But it also proved a turning point for the Chinese and the Marathon. Deng obtained far more than had Mao. On January 31, 1979, during his visit to the United States, Deng and Fang Yi, director of the State Science and Technology Commission, signed agreements with the U.S. government to speed up scientific exchanges. That year, the first fifty Chinese students flew to America. In the first five years of exchanges, some nineteen thousand Chinese students would study at American universities, mainly in the physical sciences, health sciences, and engineering, and their numbers would continue to increase.52 Carter and Deng also signed agreements on consular offices, trade, science, and technology—with the United States providing all sorts of scientific and technical knowledge to Chinese scientists in what would amount to the greatest outpouring of American scientific and technological expertise in history. The Chinese reached out to the U.S. National Academy of Sciences to send a series of delegations to China to initiate U.S.-China scientific exchanges in several fields China had selected. The Chinese strategy was to get the Americans to ensure their admission to all international organizations dealing with physics, atomic energy, astronautics, and other fields.

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The Americans agreed, thus making an eighth offer to China. The Americans also agreed to engage in more covert military cooperation. President Carter provided China with intelligence support to aid China's war in Vietnam, to a degree that shocked even Henry Kissinger, as he described in his 2011 book On China. In tones suggesting that perhaps he'd created a monster by opening the door to ties with Beijing, Kissinger denounced Carter's "informal collusion" with what was "tantamount to overt military aggression" by Beijing—aid that "had the practical effect of indirectly assisting the remnants of the Khmer Rouge."53 A visit to China by Secretary of Defense Harold Brown, Kissinger fumed, "marked a further step toward Sino-American cooperation unimaginable only a few years earlier."

The ninth offer, Presidential Directive 43, signed in 1978, established numerous programs to transfer American scientific and technological developments to China in the fields of education, energy, agriculture, space, geosciences, commerce, and public health.54 The following year, the Carter administration granted China most-favored-nation status as a U.S. trading partner.

President Carter also authorized the establishment of signals intelligence collection sites in northwestern China in about 1979, as the CIA operative and future U.S. ambassador to China James Lilley described in his memoir, China Hands. "Part of the reason I was awarded a medal from the CIA was my work setting up the first CIA unit in Beijing," Lilley wrote. "Another contributing fact was my role in developing intelligence sharing with China.... It sounded like a far-fetched idea—the United States and China, who had been fighting each other through surrogates just a few years earlier in Vietnam, working together to collect strategic technical intelligence on the Soviet Union."55

* * *

In 1978, I was serving as a professional staff member on the U.S. Senate Budget Committee, and I also worked as a consultant to the Defense Department, where I continued to read classified analyses on China and produced reports and analyses of my own. As Ronald Reagan mounted a second bid for the White House in 1980, I was appointed as one of his advisers, and I helped draft his first campaign speech on foreign policy. I expressed a view, common among his advisers, that the United States ought to help China to stave off the far greater Soviet threat. After Reagan won the election, I was named to the presidential transition team. I then advocated still more cooperation. An early ally in my efforts was Alexander Haig, who knew all about the earlier efforts with China under the Carter administration, and now as secretary of state visited Beijing and publicly offered to sell weapons to China, the next logical step.

National Security Decision Directive (NSDD) 11, signed by President Reagan in 1981, permitted the Pentagon to sell advanced air, ground, naval, and missile technology to the Chinese to transform the People's Liberation Army into a world-class fighting force. The following year, Reagan's NSDD 12 inaugurated nuclear cooperation and development between the United States and China, to expand China's military and civilian nuclear programs.

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Reagan was deeply skeptical of his predecessor's policies toward China—a stance that led to a serious policy disagreement within the administration. Reagan saw China's underlying nature better than I did and better than most of the China experts who would populate his administration. On the surface, Reagan followed the Nixon-Ford-Carter line of building up China—"to help China modernize, on the grounds that a strong, secure, and stable China can be an increasing force for peace, both in Asia and in the world," in the words of Reagan's NSDD 140, issued in 1984. (Significantly, the NSC staff severely limited access to NSDD 140—only fifteen copies were produced—probably at least in part because it outlined the Reagan administration's controversial goal of strengthening China.)56

Reagan signed these secret directives to help build a strong China and even offered to sell arms to the Chinese and to reduce arms sales to Taiwan. But unlike his predecessors, Reagan added a caveat that should have been crucial. His directives stated that U.S. assistance to China was conditioned on China staying independent of the Soviet Union and liberalizing its authoritarian system. Unfortunately, his advisers largely ignored these preconditions, and for whatever reason so did he.

Additionally, the Reagan administration provided funding and training to newly established Chinese government-run institutes specializing in genetic engineering, automation, biotechnology, lasers, space technology, manned spaceflight, intelligent robotics, and more. Reagan even approved a Chinese military delegation visit to one of the crown jewels of national security, the Defense Advanced Research Projects Agency, the research agency that invented the Internet, cyber operations, and dozens of other high-tech programs.

During the Reagan presidency, America's covert military cooperation with China expanded to previously inconceivable levels. The United States secretly worked with China to provide military supplies to the anti-Soviet Afghan rebels, the Khmer Rouge, and the anti-Cuban forces in Angola. Our cooperation against the Vietnamese occupation of Cambodia—including the arming of fifty thousand anti-Vietnam guerrillas—was discussed in interviews by four of the CIA officers who revealed the details of this program in the book The Cambodian Wars.57 There was a much larger secret that other CIA officers revealed in George Crile's book Charlie Wilson's War, the story of America's purchase of $2 billion in weapons from China for the anti-Soviet Afghan rebels.58 Kissinger's memoirs reveal that there was covert cooperation in Angola as well.59

Why did China seek to cooperate with the United States on these large-scale covert actions? We will definitively find out only when Beijing opens its archives or a very high-level defector arrives. One thing we know now is that Beijing wanted to use American power and technology to strengthen China for the long term. The key point seems to have been the perceived need to play strategic wei qi, to head off encirclement by the Soviet Union. No one saw this as an effort to make broader progress in the Marathon. China made itself seem weak and defensive to us, in need of protection.

In the tenth offer, U.S.-Chinese intelligence gathering along China's border with the Soviet Union—code-named the Chestnut program—was approved, according to the New York Times reporter Patrick Tyler. Later, during an August 1979 trip to China by Carter's vice president, Walter Mondale, the Pentagon and the CIA airlifted to China the Chestnut monitoring stations via military transport. Tellingly, Tyler reported, the Chinese asked the U.S. Air Force C-141 Starlifter at the Beijing airport to park beside a Soviet passenger jet so the Soviets would see the cooperation.60

According to Tyler, these monitoring stations could collect information about air traffic, radar signals from Soviet air defenses, and KGB communications, and they could also detect any change in the alert status of Soviet nuclear forces.61 Thus China would have an increase in its warning time in the event of a Soviet attack. This was a huge advance in Chinese security in the months before the attempted encirclement that would begin with the Soviet-backed Vietnamese invasion of Cambodia and the Soviet invasion of Afghanistan in December 1979. Through their patience, the Chinese were getting more than what Kissinger, Iklé, and I had proposed six years earlier.

According to the requirements of shi, Beijing must have thought it needed America's help to break up the two "pincers" of the Soviet encirclement of China—in Afghanistan and Vietnam. The circumstances justified going farther than Mao had; Deng would accept significant aid from the hegemon.62

From 1982 through 1989, the Sino-American Cambodian program was run out of Bangkok, with the support of the Chinese, the Royal Thai Army, Singapore, and Malaysia. This constituted the eleventh offer of U.S. assistance to China. The covert cooperation was effectively masked for two decades because it was partly overt. USAID provided funds named for the program advocates, Representative Bill McCollum, a Republican from Florida, and Representative Stephen Solarz, a Democrat from New York, for nonlethal humanitarian assistance in Cambodia. Behind these two overt programs, Reagan ordered the CIA to provide covert assistance initially in 1982 for $2 million a year, and that was raised as of 1986 to $12 million, as Kenneth Conboy notes.63 The program was commingled under a project the Thais called Project 328. China, Malaysia, Singapore, and Thailand also contributed weapons and funds. Singapore's prime minister Lee Kuan Yew even visited Bangkok to travel to the secret camp. I visited in 1985 and 1986, to be briefed by the CIA station chief, who had transferred to Bangkok after serving as head of the Far East Division at CIA headquarters. He considered the project "the only game in town," referring to the Cold War, with China joining up against the Soviets.64

Starting in the summer of 1984, two years after the program in Cambodia began, Chinese covert cooperation to drive the Soviets out of Afghanistan would become fifty times larger than its effort in Cambodia.

We did not understand shi and counter-encirclement at that time, and therefore no one thought the Chinese government would risk Soviet wrath by becoming a major arms supplier to America's efforts to aid the Afghan rebels. The discovery was made by a brilliant, Mandarin-

speaking CIA friend, Joe DeTrani.65 This Chinese connection was a tightly held secret, and no more than ten people in the entire CIA were aware of the program, according to Tyler. The Chinese still do not acknowledge that they provided such arms. In his book Charlie Wilson's War, George Crile reports that the first order was for AK-47 assault rifles, machine guns, rocket-propelled antitank grenades, and land mines.66

In 1984, Representative Charlie Wilson had drummed up $50 million to increase support for the rebels in Afghanistan. Crile reports that the CIA decided to spend $38 million of it to buy weapons from the Chinese government. The Washington Post in 1990 quoted anonymous sources that said that the total value of weapons provided by China exceeded $2 billion during the six years of Sino-American covert cooperation.

U.S.-Chinese clandestine cooperation reached its peak during the Reagan administration. Presidents Nixon and Ford had offered China intelligence about the Soviets. President Carter established the Chestnut eavesdropping project. But it was Reagan who treated China as a full strategic partner—albeit in secret.

The three main projects were clandestine aid to the anti-Soviet rebels in Afghanistan, Cambodia, and Angola. By now, I had been promoted to the civilian equivalent of a three-star general and made head of policy planning and covert action in the Pentagon, reporting to the official in charge of policy, Fred Iklé. Iklé and I were among the few who knew about Kissinger's 1973 offer to aid China and President Carter's Chestnut program. He and I were ready to test whether China was really willing to become a U.S. ally. The affirmative results would prejudice many senior U.S. officials to favor China for years to come.

My duty was to visit the leaders of the Afghan, Cambodian, and Angolan rebel groups in Islamabad, Bangkok, and southern Angola, respectively, to ascertain their plans and needs. I was also sent to obtain China's advice, approval, and support. We recommended that President Reagan sign National Security Decision Directive (NSDD) 166, which reflected that there was a chance that escalation in Afghanistan could provoke retaliation by the Soviets.67 We needed China's assessment of the situation and, ideally, its support.

Two decades later, the journalist Steve Coll alleged that "the Chinese communists cleared huge profit margins on weapons they sold in deals negotiated by the CIA."68 If the assertion is accurate that $2 billion was spent on Chinese weapons for the anti-Soviet rebel groups, then China's purchase of more than $500 million in American military equipment for itself seems relatively small.

The Chinese not only sold the weapons to us to give to the rebels, but also advised us how to conduct these covert operations. From their advice emerged a few lessons about Chinese strategy toward a declining hegemon, in this case the Soviet Union. First, the Chinese emphasized that we had to identify key Soviet vulnerabilities to exploit. One tactic, they explained, was to raise the cost of empire. When I first proposed the option of supplying Stinger antiaircraft missiles to the Afghan and Angolan rebels, the Chinese were delighted at the high

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costs that these weapons would impose, in the form of destroyed Soviet helicopters and jet fighters.

The second idea was to persuade others to do the fighting. This was of course a manifestation of the Warring States–era notion of wu wei.

The third concept was to attack the allies of the declining hegemon. The Cambodian rebels worked against the Soviets' Vietnamese puppets. The Angolan rebels expelled the Cubans, who had been flown to Angola in Soviet aircraft that might also have been shot down with Stingers, if they had been made available then. The United States, in cooperation with China, did all this, and more.

I asked the Chinese whether they thought it would be excessively provocative to take two additional steps: Should we supply and encourage Afghan rebels to conduct commando sabotage raids inside the Soviet Union (which had never been done during the Cold War)? And should we agree to the request to provide the Afghans with long-range sniper rifles, night-vision goggles, and maps with the locations of high-ranking Soviet officials serving in Afghanistan in support of what amounted to a targeted assassination program? My colleagues had been certain that the Chinese would draw the line at such actions. I had read enough Chinese history to guess that they would agree, but even I was taken aback at the ruthlessness of Beijing's ambition to bring down the Soviets when they answered affirmatively to the two questions.

Steve Coll wrote in his Pulitzer Prize–winning book Ghost Wars that it was the American side that declined these requests. He writes of "alarms" among the CIA's lawyers that it was almost "outright assassination" and so the local CIA station chief "might end up in handcuffs."69 So the sniper rifles could be approved but not the maps and night-vision goggles. The commando raids inside Soviet territory, favored by the Chinese as a way to bring down the Russian hegemon, were soon curtailed as well, in spite of the Chinese recommendation to us that this would have a useful psychological shock effect on the declining hegemon.70

In 1985, the aid to the Chinese Marathon expanded to include American weapons, as the Reagan administration arranged for the sale of six major weapons systems to China for more than $1 billion. This program aimed to strengthen China's army, navy, and air force and even to help China expand its marine corps.71 And in March 1986 the Reagan administration assisted China's development of eight national research centers focused on genetic engineering, intelligent robotics, artificial intelligence, automation, biotechnology, lasers, supercomputers, space technology, and manned spaceflight.72 Before long, the Chinese had made significant progress on more than ten thousand projects, all heavily dependent on Western assistance and all crucial to China's Marathon strategy. The Reagan administration hoped it was countering Soviet power by giving a boost to the Chinese, and everyone—from Reagan on down—wanted to believe Beijing's claims that China was moving toward greater liberalization.

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China's strategy to break the Soviet encirclement with help from its fellow Warring State was succeeding. In 1989, the Soviets announced they would leave Afghanistan, and Vietnam soon withdrew from Cambodia. Now, would Washington and Beijing build on this foundation of trust and therefore become true allies forever? I thought so. But according to the Warring States' axioms, now would be the time for China to get back to dealing with the real hegemon, the United States.

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Statement of
Wilbur L. Ross
Secretary of Commerce

Before the
Senate Finance Committee
June 20, 2018

Chairman Hatch, Ranking Member Wyden, and Members of the Committee:

The reports that I submitted to the President in January pursuant to Section 232 of the Trade Expansion Act of 1962 found that steel and aluminum imports threaten to impair our national security. The President determined that tariffs are necessary to address this threat. As a result, the President signed proclamations on March 8 imposing a 25 percent tariff on steel imports and a ten percent tariff on aluminum imports. The President subsequently signed additional proclamations on March 22, April 30 and May 31, and modified the tariffs with respect to steel imports from Australia, Argentina, Brazil, and South Korea, and aluminum imports from Australia and Argentina. The President's Section 232 decisions are the result of a robust and thorough interagency review coordinated by the White House.

The tariff actions taken by the President are necessary to protect America's essential steel and aluminum industries, which have been harmed by the quantities and circumstances of imports to the point that allowing imports to continue unchecked threatens to impair our national security. These imports stem from a variety of reasons, including industrial export policies of our trading partners, unfair trade practices, and massive global excess production, particularly by China.

I initiated the steel and aluminum Section 232 investigations in April 2017 and the President signed two memoranda that month directing me to proceed expeditiously to conduct these investigations and report my findings. The Department provided a 30-day public comment period and held three days of hearings. Section 232 investigations include consideration of: domestic production needed for projected national defense requirements; domestic industry's capacity to meet those requirements; the existing and anticipated availabilities of human resources, products, raw materials, production equipment and facilities, and other supplies and services essential to the national defense; the growth requirements of domestic industries to meet national defense requirements and the supplies and services, including the investment, exploration and development necessary to assure such growth; the impact of foreign competition on the economic welfare of individual domestic industries; and any substantial unemployment, decrease in revenues of government, loss of skills or investment, or other serious effects resulting from the displacement of domestic products by excessive imports, without excluding other factors, in determining whether such weakening of our internal economy may impair the national security.

We concluded that steel import levels and global excess capacity are weakening our domestic economy and therefore threaten to impair our national security. The level of foreign steel imports has been greater than 30 percent for the past four years and threatens to impair the national security by displacing domestic production. Six basic oxygen furnaces and four electric

arc furnaces had closed since 2000 and employment has dropped 35 percent since 1998. Global excess capacity will cause U.S. producers to face more and more competition from foreign imports as other countries increase their exports to further their own economic objectives. China is by far the largest producer and exporter of steel, and the largest source of excess steel capacity. China's excess capacity alone exceeds the total U.S. steel-making capacity by at least three times. Even more importantly, China exported 40 percent more steel than the U.S. produced in 2015 and 36 percent more in 2016. In 2017 China reduced its exports, but still exported an amount of steel equal to 90 percent of total U.S. production.

We also concluded that the quantities and circumstances of aluminum imports are weakening our economy and threaten to impair national security. Rising levels of foreign imports put domestic producers at risk of losing the capacity to produce aluminum needed to support critical infrastructure and national defense. Aluminum imports had risen to 90 percent of total domestic demand for primary aluminum, up from 66 percent in 2012. From 2013-2016, aluminum industry employment fell by 58 percent, six smelters shut down, and only two of the remaining five smelters are operating at capacity, even though demand has grown considerably. The report found that excess production and capacity, particularly in China, has been a major factor in the decline of domestic aluminum production. We concluded that if no action were taken, the United States could be in danger of losing the capability to smelt primary aluminum altogether.

The tariffs on steel and aluminum are anticipated to reduce imports to levels needed for these industries, in combination with good management, to achieve long-term viability. As a result, these industries will be able to re-open closed mills, sustain a skilled workforce, invest in needed research and development, and maintain or increase production. The strengthening of our domestic steel and aluminum industries will reduce our reliance on foreign producers. It will take time for U.S. steel and aluminum producers to fully restart idled capacity and regain long-term financial health.

However, industry has started taking actions to restart idled capacity:

- U.S. Steel is restarting two steel blast furnaces in Granite City, Illinois, adding approximately 2.5 million metric tons of steel capacity available for U.S. consumers
- Republic Steel is restarting an idled steel electric arc furnace in Lorain, Ohio
- Liberty Steel is reopening its wire rod coil steel facility in Georgetown, South Carolina
- Magnitude 7 Metals is restarting 236,000 metric tons of aluminum production in Marston, Missouri
- Century Aluminum is investing $100 million dollars to restart and modernize its high purity aluminum smelter in Hawesville, Kentucky
- India's JSW Steel Limited announced in March 2018 that it paid nearly $81 million to acquire the Acero Junction facility near Steubenville, Ohio

The United States is not the only country that has expressed concern about the types of unfair trade practices and excess capacity that are prevalent in the steel and aluminum industries. Countries like China have provided massive subsidies to their companies, and this is harming

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markets worldwide. Recognizing our shared concern about global excess capacity, the President's proclamations announcing these actions welcomed any country with which we have a security relationship to discuss alternate ways to address the threatened impairment of the national security caused by imports from that country.

In addition, the President authorized the establishment of a mechanism for U.S. parties to apply for exclusions from the applicable tariff for specific products based on demand that is unmet by domestic production or for specific national security considerations. This process is being managed by the Commerce Department in consultation with other federal agencies. We published an interim final rule in the *Federal Register* on March 19 establishing the procedures for the exclusion process.

Today, we are announcing our first determinations on 98 exclusion requests for steel products, granting 42 requests and denying 56. Commerce has received more than 20,000 steel and aluminum exclusion requests (including resubmissions) and has posted more than 9,200 for public review and comment. Commerce has also received more than 2,300 objections to exclusion requests. Review of exclusion requests and related objections is being conducted on a case-by-case basis in a fair and transparent process. Commerce is making an unprecedented effort to process the requests expeditiously. The public comment period on the interim final rule ended on May 18, and we are reviewing the comments received to assess whether any revisions to the process are necessary.

On May 23, I also initiated an investigation under Section 232 to determine whether imports of automobiles and automotive parts into the United States threaten to impair the national security. Automobile manufacturing has long been a significant source of American technological innovation. This investigation will examine the United States' production capabilities and technologies needed for projected national defense requirements and the adverse effects of foreign competition on our internal economy. As with the steel and aluminum investigations, there is a transparent notice and comment period: a Federal Register notice was issued on May 30 inviting public comments, which are due by June 22. Public hearings on the investigation will be held on July 19 and 20.

This Administration is standing up for American families, American businesses, and American workers by taking action to reduce imports that threaten our national security.

Thank you for allowing me to testify on this important matter, and I look forward to answering questions from members of the committee.

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Trump's trade war was decades in the making

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Those who know Donald Trump say it was always going to go this way with China.

The New York real estate tycoon began issuing bitter tirades against foreign countries "ripping off" the United States on trade back in the 1980s. At an expletive-laden political rally in Las Vegas in 2011, Trump hinted at a future presidential campaign and promised to tell the Chinese: "Listen you mother******s we're going to tax you 25 percent!"

So when the clock flipped to 12:01 a.m. on Friday morning and the U.S. fired the first major shot in a trade war with China that has Wall Street and corporate America petrified, those who know the president mostly shrugged it off as Trump doing what he was always going to do, no matter the dire warnings from his "globalist" advisers.

"I always believed he was deadly serious about China from the very beginning," said Stephen Moore, a conservative economist and outside White House adviser, recalling his time with Trump during the campaign. "I'm not at all surprised that we've come to this point. I am a little surprised that China hasn't been more conciliatory. But I think Trump can't back down, he just can't. He has to stand toe to toe with China."

But now that Trump is deep into the trade fight he desperately wanted, there's no clear exit strategy and no explicit plans to negotiate new rules of the road with China, leaving the global trade community and financial markets wracked with uncertainty. As cargo ships head to ports in China with U.S. exports and Chinese ships head to U.S. ports, the new tariffs threaten to disrupt the established economic world order in ways that will soon cause pain for American and Chinese consumers.

So what?, say Trump true believers. The president is playing a long game.

"He has preached a confrontation with China for 30 years. The one thing he has been the most consistent on for his entire career is the economic threat posed by China," former Trump senior adviser Steve Bannon told POLITICO in an interview. "This is a huge moment, a historical moment. It's really Trump against all of Wall Street."

While some saw a trade war with China as inevitable given the president's history, the journey from Trump's escalator-ride campaign announcement to the dawn of a trade war between the globe's two largest

economies took many sharp turns featuring Oval Office shouting matches, the Treasury secretary declaring the trade war "on hold" only to be rebuffed and Trump's former top economic adviser Gary Cohn calling hawkish trade adviser Peter Navarro a liar to his face.

The recent history of the trade war began with Trump's campaign announcement speech on June 16, 2015 in Manhattan, in which the reality TV star candidate mentioned China 25 times.

"People say you don't like China. No, I love them," he said. "But their leaders are much smarter than our leaders. And we can't sustain ourselves with that. It's like, take the New England Patriots and Tom Brady and have them play your high school football team."

Trump shocked much of the world and rode his populist message into the White House. In his darkly apocalyptic inauguration speech, Trump made his plans clear:

"We've made other countries rich while the wealth, strength and confidence of our country has disappeared over the horizon," Trump said. "One by one, the factories shuttered and left our shores, with not even a thought about the millions upon millions of American workers left behind."

While Trump swept into the Oval Office preaching fire and brimstone on trade, during his first year in office, his protectionist impulses were mostly held in check by advisers like Cohn and Treasury Secretary Steven Mnuchin, who advocated a more traditionally Republican approach to trade policy. With the help of Agriculture Secretary Sonny Perdue, they argued Trump out of withdrawing from NAFTA in April 2017.

Cohn argued to Trump at the time that unilaterally pulling out of NAFTA would tank the stock market and complicate White House efforts to pass a big tax cut bill that was priority No. 1 for the GOP.

Navarro saw his role diminished when Trump placed him under Cohn's supervision at the National Economic Council. But just as Cohn and Mnuchin were winning battles on NAFTA, the wheels spun into motion for later showdowns over steel and aluminum tariffs and the larger trade battle with China.

In April of 2017, Commerce Secretary Wilbur Ross, at Trump's direction, launched two probes that would result one year later in Trump imposing a 25 percent tariff on steel and 10 percent tariff on aluminum, angering China, the European Union, Canada and a long list of other trading partners.

They also led directly to Cohn's resignation. The NEC director, who argued repeatedly to Trump that the tariffs would slam U.S. manufacturers, decided he'd had enough and quit in March of this year, replaced by Larry Kudlow, an affable free-trader and former CNBC host much less likely to contradict the president.

The direct path to the trade war with China began in August of last year when, at Trump's direction, U.S. Trade Representative Robert Lighthizer launched an investigation under Section 301 of the 1974 Trade Act, which allows the president to restrict exports to put pressure on another country to change its trade practices.

In March, USTR released a report accusing China of unfairly acquiring valuable U.S. intellectual property, either through outright theft, forced technology transfers or other means.

Based on that report, Trump ordered Lighthizer to draw up a list of $50 billion worth of Chinese goods that would be hit with an additional 25 percent tariff. USTR published that list in early April, targeting a number of intermediate products used in manufacturing, but also some consumer items like birth control pills and flat-panel TVs.

However, after a public hearing on the proposed list, USTR dropped televisions, birth control and some other items from its product list, while adding new ones like semiconductors. That resulted in two different lists, one

totaling about $34 billion of goods and the other totaling $16 billion subject to further review.

Beijing promptly responded by threatening increased duties on $50 billion worth of U.S. exports, including a big-ticket agricultural item — soybeans — as well as seafood, electric cars and whiskey. But once the United States divided its retaliation lists into two parts, Beijing did the same.

Senior U.S. and Chinese officials met at least three times in the following months — twice in Beijing and once in Washington — but failed to reach an agreement that would persuade Trump not to go forward with the duties, despite rising concern from the business community and many Republican members of Congress.

A trip to Beijing in May of this year laid bare the sharp divisions within the administration on China.

Navarro and Mnuchin got into a widely reported shouting match on the sidelines of the talks. And the pair brought their differences back with them. Mnuchin declared in a "Fox News Sunday" interview on May 20 that the trade was on "on hold" and urged the president to consider China's offers to buy more American goods to reduce the trade deficit and avoid a tariff battle. Navarro quickly rebuked him in an NPR interview, calling the Treasury secretary's remarks an "unfortunate sound bite."

Behind the scenes, the Mnuchin-Navarro relationship grew even worse, people close to them said, with each privately blaming the other for leaking damaging information about them to the press. One person familiar with the issue said the true extent of their disdain for each other had actually been underplayed by the media.

Mnuchin's critics in the administration cast him as a China policy neophyte who was played by Beijing. Mnuchin's "on hold" comment also produced tacit pushback from Lighthizer, who put out a statement stressing that tariffs were a crucial option to "protect our technology" against the Chinese.

Navarro, for his part, was attacked internally as an out-of-touch hothead who couldn't be trusted with sensitive negotiations. The long-time China critic was said to be furious about the leaking of his argument with Mnuchin on the sidelines in Beijing, believing it was intended to make him look short-tempered and rationalize his being kept out of upcoming talks with the Chinese in Washington, according to a person involved in the process.

Still, Mnuchin was not the only one hopeful about avoiding a trade war after returning from Beijing. Kudlow felt good too.

"I never felt we'd get a concrete deal," the NEC director said in an interview from his West Wing office shortly after returning from the trip, in which the White House laid out its "asks" for the Chinese. "They engaged us on that, it's good. This is going to be a process."

That process never got very far.

Trump toyed with the idea of reaching a grand bargain with the Chinese that would avert the tariffs. And he stunned Capitol Hill and much of the world when he tweeted on May 13 that he was working with Chinese President Xi Jinping on a deal to get Chinese telecom giant ZTE, sharply sanctioned by the United States, "back in business."

The White House has continued pushing to help ZTE, over congressional GOP opposition, largely as part of an effort to get Xi and the Chinese to help on diplomacy with North Korea. Trump also surprised his more hawkish advisers late last month when he took Mnuchin's side in declining to impose investment restrictions exclusively on China.

But that decision and the efforts toward a ZTE deal were just sideshows as Trump marched toward the wider

trade war with China.

People close to the president said he was always skeptical of the kind of grand bargain with China on trade that Mnuchin attempted to bring back from Beijing. In the end, Trump was unsatisfied with the early contours of the agreement, which included a demand to cut China's trade surplus by $200 billion.

The failure of Mnuchin and other like-minded advisers to head off a trade with China concluded on Friday when U.S. duties on $34 billion on Chinese exports to the U.S. went into effect. USTR will hold another hearing and public comment period on the remaining $16 billion. China similarly divided its retaliation into two tranches to respond in kind as U.S. duties are imposed.

Trump told reporters on Air Force One on Thursday night that the U.S. was laying plans to impose close to $500 billion in total tariffs on China, a figure that would cover all kinds of consumer products from televisions to toaster ovens. The U.S. imported a total of $505 billion worth of goods from China last year.

There is little sense, even among the free-traders inside the administration, that the White House will back down from the Chinese tariffs anytime soon. It's a defining issue for Trump, according to people close to the White House.

Administration officials told people last week not to expect the White House to "blink" on its tariffs in the near term. Right now, the president views the tariffs as a winning political issue heading into the midterms, despite protests from The Wall Street Journal editorial board, business groups and so-called elites or donors.

These various constituencies that support free trade are now trying to take the long view on the tariffs — hoping they end once an event like a drop in the stock market, an increase in prices of consumer goods or the conclusion of the midterms makes the political argument less palatable.

For a president who frequently changes direction on policy, trade is one area where advisers argue Trump is carrying out his campaign promises and setting himself up to make trade a major talking point in the 2018 midterms and even 2020.

"Obviously, Trump realizes that if you extrapolate things out over the next 10 to 15 years, the U.S. is at a disadvantage compared to other countries unless we fix the trade set ups," said one of the Republicans close the White House. "The president is looking down the road to try to help the workers or industries most affected by this."

For Trump's nationalist advisers, the fierce internal debate over whether to hit China with tariffs amounted to a battle over the soul of Trumpism. And on Friday, they were privately declaring victory, arguing that the so-called globalists they have long ridiculed — and feared — had been defeated.

"Reagan had Russia; Trump has China," Bannon said. "For over four decades the establishment said this day could never happen — with Trump it did."

Megan Cassella and Maria Curi contributed to this report.

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US-China trade war
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Donald Trump
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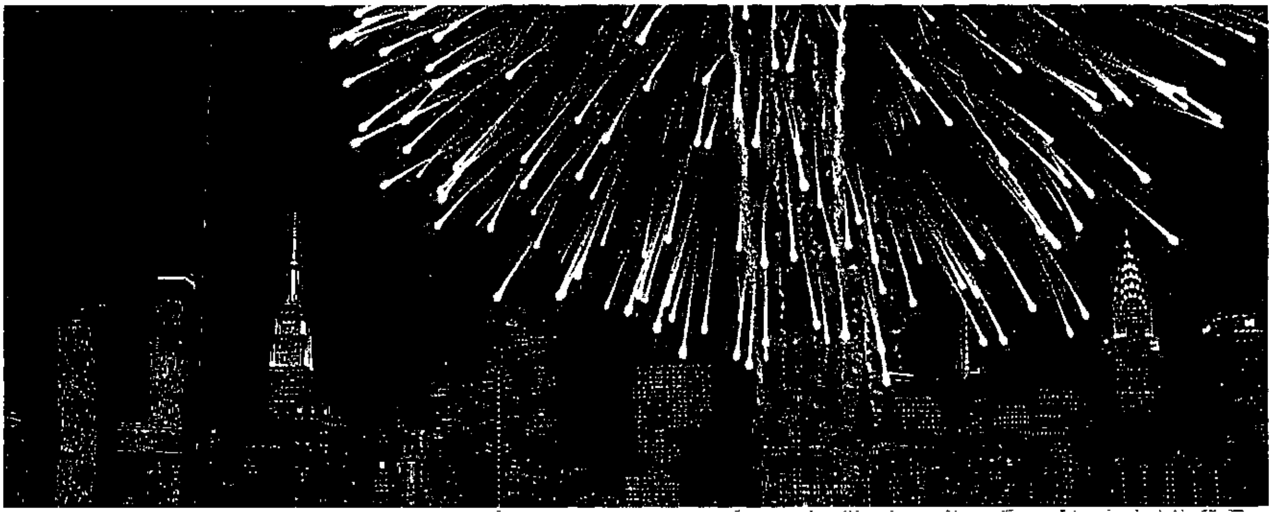
THIS WEEK IN ASIA



TOPIC US-CHINA TRADE WAR

US AND CHINA: WHO TRIED TO AVERT A TRADE WAR AND WHO FORCED IT?

The two have moved in entirely opposite directions over the past six weeks when it comes to fulfilling the bilateral obligations stemming from their May 19 agreement

BY SOURABH GUPTA
7 JUL 2018

Fireworks, speeches, barbecues and feasts have traditionally marked America's Fourth of July festivities going back to the 18th century. Add tit-for-tat retaliatory tariffs to the celebratory mix this year. In the week that America celebrated its 242nd birthday, the Donald Trump (https://www.scmp.com/topics/donald-trump) administration and its trade partners on both sides of the Pacific busied themselves enacting punitive duties on each other's exports.

Canada went first, imposing duties on US$12.5 billion of US exports on July 1 (appropriately also Canada Day) in response to Trump's steel and aluminium tariffs that kicked in last month.

On July 5, Mexico followed suit with its second tranche of duties on US$3 billion worth of US exports – mostly agricultural products, also in response to Trump's steel and aluminium tariffs. On Friday, US$34 billion worth of Chinese exports to the US across 818 tariff lines were subject to an additional 25 per cent duty.

US-China trade war: not about trade, not about Trump. Here's what it is about →

When these Section 301 duties go into effect, Trump will have plumbed yet another a low in his already dismally low governing record. From the Iran deal to the Paris climate agreement to the Trans-Pacific Partnership (https://www.scmp.com/topics/trans-pacific-partnership) (TPP) agreement, Trump has had no compunction tearing up solemn international commitments entered into by his predecessors. The imposition of these tariffs on China would constitute the first instance, however, of him materially reneging on his own solemn commitment to an international partner.

Chinese Vice-Premier Liu He. Photo: AFP.

Over the third weekend of May, Trump's Treasury Secretary Steven Mnuchin and President Xi Jinping (https://www.scmp.com/topics/xi-jinping)'s economic tsar, Vice-Premier Liu He, delivered a win-win, principles-based deal to tide over the seemingly indissoluble US-China trade, investment and intellectual property rights quarrels. Suspending the US$50 billion worth of Section 301 tariffs was at the core of their consensus.

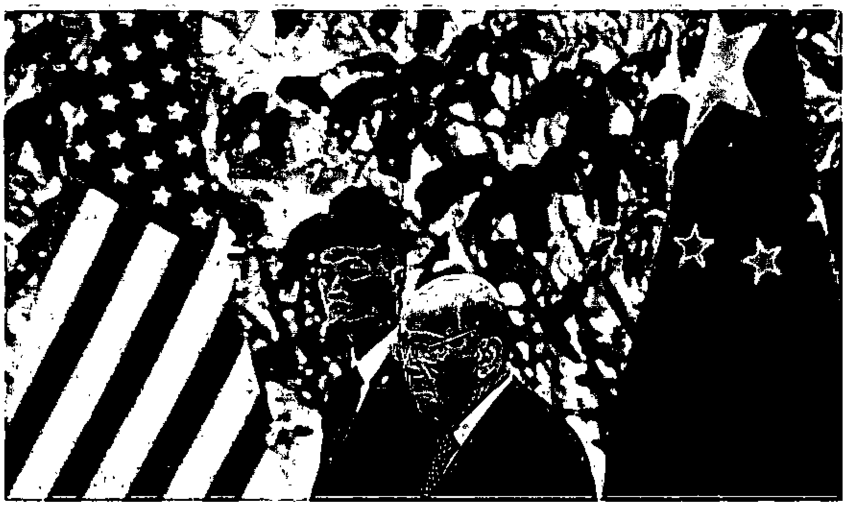
China has 'nuclear options' in trade war with US ... really? →

In exchange for setting aside tariffs, the US was to enjoy ramped-up agriculture and energy sales in the Chinese market, ensure that Beijing's patent laws got appropriately tweaked, obtain gradual investment liberalisation in additional Chinese sectors, and subject Chinese investment in the US to qualitatively more checks. They released a statement on May 19 that confirmed their consensus and in an Oval Office meeting, Trump blessed it expressly.

WATCH: Trade war threatens China's love for American barbecue

It now appears that Trump, the self-professed negotiating virtuoso, can neither deliver on his word nor on the lone US concession within a principles-based agreement that is hugely tilted in his country's favour. In the six weeks since the formalisation of the joint consensus, the US and China have been a study in contrasts in terms of its implementation.

During the first week of June, US Commerce Secretary Wilbur Ross paid a productive visit to Beijing during which US$50 billion of sector-by-sector and product-by-product purchase contracts capable of sustaining half a million American jobs were discussed. More importantly, marked progress was achieved in narrowing down differences related to a number of long-standing technical and regulatory irritants, including plant biotechnology trait non-approvals, that have held back US agricultural sales in the Chinese market.



US Commerce Secretary Wilbur Ross at the Diaoyutai State Guesthouse for his meeting with Chinese Vice-Premier Liu He. Photo: Reuters

On June 10, China's State Council issued a highly awaited circular that significantly increases the level of investment liberalisation and improves the level of investment protection. Pursuant to the circular, China's negative list for foreign investment is to be pared down by a quarter from 2017 levels (and by half from 2015 levels), starting July 28, and meaningful openings are slated in areas such as seeds, automotive manufacturing, aircraft manufacturing and power grids, which the government had hitherto been reluctant to open up.

China and Trump's tariffs: stop, or I'll shoot myself too →

The next day, a draft revision of China's Patent Law, awaiting a reading at the mid-month National People's Congress Standing Committee session, was withdrawn at short notice from the session's agenda. The likely purpose was to make studied amendments to the draft to incorporate revised provisions on technology licensing as well as substantially increase the legal compensation limit for domestic intellectual property infringement. Both would be in keeping with the commitments expressed in the May 19 Mnuchin-He consensus.

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New cars at the Auto Warehousing Company near the Port of Richmond in California. Photo: AFP

All along, Beijing has continued to lower its tariff barriers, eliminating import tariffs on common drugs as well as reducing its duties on automobiles, auto parts and a swathe of consumer and household items starting from July 1. In a nutshell, the Xi government proceeded with sincerity to fulfil its side of the May 19 bargain.

The same cannot be said of the Trump administration. Barely 10 days after the ink had dried – and with no perceptible negative shift at the Chinese end – Trump reversed course and announced the US would go ahead and impose the Section 301 tariffs on China. A final list of covered imports was announced on June 15 with tariffs set to go into effect three weeks later.

Trump's promise to partially rehabilitate the US operations of the Chinese telecommunications company ZTE have become mired in Congress-White House discord. Photo: Reuters

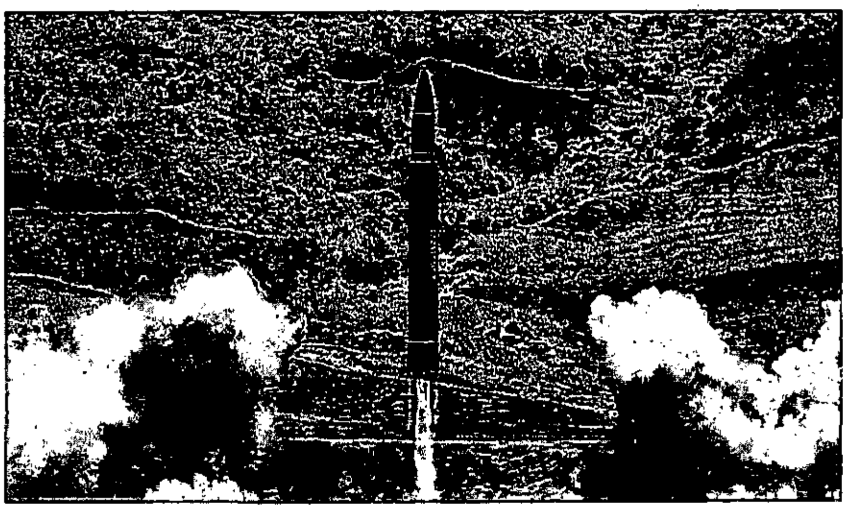
On June 27, a stricter foreign investment screening regime against China and other countries of concern was announced. Henceforth, a broader range of Chinese investors – be it majority or minority equity holders, seed-stage venture capitalists, or intellectual property licensees – are to be barred from acquiring militarily and industrially significant technologies in the US.

Separately, Trump's promise to partially rehabilitate the US operations of the punished-and-chastened Chinese telecommunications company ZTE have also become mired in Congress-White House discord.

Donald Trump pr

Clearly, the US and China have moved in entirely opposite directions over the past six weeks with regard to fulfilling the bilateral obligations stemming from their May 19 agreement.

But all should not be considered lost. Mercurial turnarounds have been a feature of this dysfunctional administration in Washington and more such turnarounds – this time for the better – could be in store. On America's 241st birthday, North Korean leader Kim Jong-un (https://www.scmp.com/topics/kim-jong-un) gleefully "gifted" the "American bastards" his first intercontinental ballistic missile launch.



Kim Jong-un's July 4 gift to America last year. Photo: AP

Fittingly, the very day a year later that Trump's Section 301 tariffs are set to take effect against China, Secretary of State Mike Pompeo was in Pyongyang to advance denuclearisation conversations within a transformed US-North Korea (https://www.scmp.com/topics/north-korea) relationship. As remote a chance as it may seem today, a similar transformation in US-China (https://www.scmp.com/topics/china-us-relations) trade, investment and intellectual property rights-related relations is also possible.

US-China trade war: bad for business is just the beginning →

For this transformation to take shape however, the onus is on Washington to suspend its Section 301 tariffs and return to the negotiating table. China's dollar-for-dollar retaliatory tariffs and, ideally, the withdrawal of all promised market access commitments so far under the May 19 statement's deficit reduction pillar will hopefully help Trump to discover which side his political bread is buttered. If not, perhaps Beijing could partially release its foot from the North Korea sanctions pedal and make the American president's imagined linkage of North Korea sanctions and China trade become a living reality. ■

Sourabh Gupta is a senior fellow at the Institute for China-America Studies in Washington

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MARCH 22,2018

Press Contact:

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Wyden Statement on China Trade Enforcement Announcement

WASHINGTON—Senate Finance Committee Ranking Member Ron Wyden, D-Ore., issued the following statement in response to an investigation by the U.S. Trade Representative into Chinese theft of U.S. technology.

"China has cheated, stolen and bullied American industry on trade for decades, causing massive economic wreckage to workers, employers and communities across America in the process," Wyden said. **"Our country must stand up against China's trade blackmail, so I am encouraged that the administration is focused on protecting the technologies that China publicly targeted. I intend to study the USTR report closely and look forward to close consultations on remedies to ensure the administration gets real results that actually bring back American jobs."**

The investigation was conducted under Section 301 of the Trade Act. Wyden in August urged U.S. Trade Representative Robert Lighthizer to investigate China's forced technology transfer policies and take action to stop China from pressuring U.S. tech manufacturers to sacrifice intellectual property as a cost of doing business in China.

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Recent News

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07/17/18 Wyden Statement on Treasury Department Announcement to Protect Dark Money Donors

CHAIRMAN'S PRESS / PRESS

JUNE 20, 2018

CORKER EXPRESSES DEEP CONCERN ABOUT TARIFF EXCLUSION PROCESS

WASHINGTON – In a letter to Secretary of Commerce Wilbur Ross, U.S. Senator Bob Corker (R-Tenn.), chairman of the Senate Foreign Relations Committee, today expressed deep concern about the implementation of steel and aluminum tariffs recently imposed by the president under Section 232 of the Trade Expansion Act of 1962 and sought assurances that the Department of Commerce will make exclusion decisions free of political interference or persuasion.

Full text of the letter is below and available online here.

Dear Mr. Secretary:

I write today to express my deep concern about the implementation of steel and aluminum tariffs recently imposed by the president under Section 232 of the Trade Expansion Act of 1962.

These tariffs already are disrupting and damaging numerous American businesses and will continue to have real world effects, including the possibility that many Americans could lose their jobs as businesses face increased costs.

As you know, the Department of Commerce has established a process for U.S. businesses injured by these tariffs to request an exclusion. According to the interim rule published on March 19, an exclusion may be

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granted if you determine the steel or aluminum product for which the exclusion is requested is not produced in the United States in a sufficient or reasonably available amount or of a satisfactory quality. You may also grant an exclusion for "specific national security" considerations.

This exclusion process, while purporting to establish fair procedures, instead opens the door for the president, through his Commerce Secretary, to pick economic winners and losers. Not only has the administration abused the Section 232 authority delegated to it by Congress under the guise of national security, but now is in a position to grant exclusions to favored companies or withhold benefits from political opponents.

The Constitution clearly gives Congress the power to collect duties and regulate foreign commerce. By subverting Section 232 and seizing unilateral power to impose or reduce tariffs at will, the administration has upset the long-standing laws and traditions of our country and shifted the balance of power within our government.

In order to allay these concerns, I request further details regarding the process for granting exclusions and seek assurances that your department will make decisions free of political interference or persuasion.

Corker is the author of bipartisan legislation that would require the president to submit to Congress any proposal to adjust imports in the interest of national security under Section 232. For a 60-day period following submission, legislation to approve the proposal will qualify for expedited consideration, guaranteeing the opportunity for debate and a vote. The requirement would apply to all Section 232 actions moving forward, as well as those taken within the past two years. The bill has attracted a wide range of support and is cosponsored by Senators Heidi Heitkamp (D-N.D.), Pat Toomey (R-Pa.), Mark Warner (D-Va.), Lamar Alexander (R-Tenn.), Brian Schatz (D-Hawaii), Ron Johnson (R-Wis.), Chris Van Hollen (D-Md.), Mike Lee (R-Utah), Jeanne Shaheen (D-N.H.), Jeff Flake (R-Ariz.), Johnny Isakson (R-Ga.), Ben Sasse (R-Neb.), and Jerry Moran (R-Kan.). Last week, Corker filed his legislation as an amendment to the NDAA. His request for an up-or-down vote was blocked by Senate leadership.

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Testimony of

Robert D. Atkinson
President
Information Technology and Innovation Foundation

Before the

House Committee on Foreign Affairs

Subcommittee on Terrorism, Nonproliferation and Trade

Hearing on China's Predatory Trade and Investment Strategy

July 11, 2018

Washington, DC

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Good afternoon Chairman Poe, Ranking Member Keating, and members of the Committee; thank you for inviting me to share the views of the Information Technology and Innovation Foundation (ITIF) on the issue of Chinese predatory trade and investment policies and what the U.S. government should do in response.

The Information Technology and Innovation Foundation is a non-partisan think tank whose mission is to formulate and promote public policies to advance technological innovation and productivity internationally, in Washington, and in the states. Recognizing the vital role of technology in ensuring prosperity, ITIF focuses on innovation, productivity, and digital economy issues. ITF has long focused on the issue of how unfair foreign policies and practices, particularly Chinese, negatively impact the U.S. economy. I very much appreciate the opportunity to comment on these issues today.

The Existential Threat of Coerced and Purloined Chinese Technology Acquisition

Ever since the first industrial revolution advanced countries have worried about technology transfer to foreign nations. For example, it was against the law to transfer technology designs outside of Britain; something that Samuel Slater did when he memorized the plans for textile machines before immigrating to the United States and establishing the first U.S. textile mill in Rhode Island.

Today the United States leads in the so-called fifth industrial revolution (information technology) and hopes to lead in the 6th (artificial intelligence, robotics, etc.), but a major threat to our leadership is technology transfer to China. China is seeking global technology dominance in an array of advanced technology industries through an unprecedented array of predatory economic and trade policies and practices, including theft of U.S. technology and coerced transfer thereof. The world has never seen a country like China before, with its organized and strategic system of authoritarian state capitalism. It is not a market economy where firms largely dictate their own strategy and behavior. It is not a country governed by the rule of law. It is not a country constrained by global norms of acceptable economic and trade behavior. It is a country where the government is concerned with one and only one economic goal: winning in advanced technology industries by any means possible.

As ITIF has documented across a series of reports—including "False Promises: The Yawning Gap Between China's WTO Commitments and Practices," "Enough is Enough: Confronting Chinese Innovation Mercantilism," and "Stopping China's Mercantilism: A Doctrine of Constructive, Alliance-Backed Confrontation "—China has deployed a vast panoply of innovation mercantilist practices that seek to unfairly advantage Chinese advanced-industry producers over foreign competitors.[1] These practices have included forced technology transfer and forced local production as a condition of market access; theft of foreign intellectual property (IP); curtailment and even outright denial of access to Chinese markets in certain sectors; manipulation of technology standards; special benefits for state-owned enterprises; capricious cases to force foreign companies to license technology at a discount; government subsidies of Chinse companies, and government-subsidized acquisitions of foreign enterprises. U.S. and foreign enterprises across virtually every advanced technology sector—from aerospace and biotechnology to information and communications technology (ICT) products, Internet, clean energy, and digital media—have been harmed by China's aggressive use of these types of innovation mercantilist policies and will continue to be harmed if China cannot be pressured to roll back its egregious predatory practices.

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In the last few years, though, the focus of China's efforts has shifted. In 2015, Chinese President Xi Jinping unabashedly trumpeted a goal of making China the "master of its own technologies."[2] China's arrival at that point resulted from the evolution of Chinese economic policy over the past two decades. Up to the mid-2000s, China's economic development strategy sought principally to induce foreign multinationals to shift relatively low- and moderate-value production to China.[3] It used an array of unfair tactics, including currency manipulation, massive subsidies, and limits on imports. That strategy changed in 2006 as China moved to a "China Inc." development model of indigenous innovation which focused on helping Chinese firms, especially those in advanced, innovation-based industries, often at the expense of foreign firms. Marking the shift was a seminal document called the "National Medium- and Long-term Program for Science and Technology Development (2006-2020)," the so-called "MLP," which called on China to master 402 core technologies, everything from intelligent automobiles to integrated circuits and high-performance computers.

The MLP announced that modern Chinese economic strategy sought absolute advantage across virtually all advanced technology industries. It rejected the notion of comparative advantage: which holds that nations should specialize in the production of products or services at which they are the most efficient and trade for the rest. Instead, China now wishes to dominate in the production of a wide array of advanced technology products including jet airplanes, semiconductors, computers, machine tools, robots, electric vehicles, artificial intelligence software, and pharmaceuticals. Essentially, Chinese policymakers wish to autarkically supply Chinese markets for advanced technology products with their own production while still benefitting from unfettered access to global markets for their technology exports and foreign direct investment (FDI).

In recent years President Xi has doubled down on this approach, through new promulgations such as the "Made in China 2025 Strategy," the "13th Five-Year Plan for Science and Technology," the "13th Five-Year Plan for National Informatization," and "The National Cybersecurity Strategy," among other policies. The "Made in China 2025 Strategy," for instance, calls for 70 percent local content in manufacturing components in China, while policies enumerated in documents such as the "13th Five-Year Plan for National Informatization" and "The National Cybersecurity Strategy" effectively deny access to U.S. enterprises seeking to compete in emerging ICT industries such as cloud computing in China. The "National Cybersecurity Strategy" further outlines a goal for China to become a strong cyber power by 2020, and that includes mastering core technologies, many of which the United States is currently the international leader in, such as operating systems, integrated circuits, big data, cloud computing, large-scale software services, the Internet of Things, 5G wireless systems, etc., as the country increasingly pursues a strategy of shutting out foreign competitors in the interest of advantaging domestic enterprises and industries. As the Mercator Institute for China Studies in Germany writes, "Made in China 2025 in its current form [means that] China's leadership systematically intervenes in domestic markets so as to benefit and facilitate the economic dominance of Chinese enterprises and to disadvantage foreign competitors."[4] For instance, with regard to ICT-enabled manufacturing (i.e., "smart manufacturing") the strategy calls for 80 percent domestic market share of high-end computer numeric controlled machines by 2025; 70 percent for robots and robot core components; 60 percent for big data; 60 percent for IT for smart manufacturing; and 50 percent for industrial software.[5]

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China's economic strategy can be summarized as follows: China seeks global competitive advantage in virtually all advanced industries. However, attaining that requires significant "learning" as the production "recipes" to make a jet aircraft, a computer chip, a genomics sequencer, a robot, or a biotech drug are incredibly complex and can't be obtained from scholarly journal articles or other widely available sources of scientific knowledge. The United States has gained competencies and leadership in these and a host of other industries the hard way: trillions of dollars of investment in R&D, production testing, workforce training, and other areas in order to master incredibly complex products and production systems. The Chinese government knows that if it proceeds the fair and "natural" way that it will take it many decades for Chinese firms to close the gap with global leaders. Most of their firms are too far behind to be able to catch up any time soon through organic and fair means. Hence, it has embraced a multifaceted set of policies and programs to obtain the knowledge and capabilities it needs from foreign producers; including through theft of intellectual property, forced joint ventures and technology transfer as a condition of market access; and state-subsidized purchases of or investments in foreign advanced industry firms. And once it obtains that know-how, it then proceeds to lavish subsidies and other benefits on its Chinese business champions so they can advance and scale up, while at the same time limiting foreign company market access in China. Once the Chinese champions have the protected "aircraft carrier" of a domestic market they provide subsidies and other incentives to enable their companies to launch attacks ("going out") to take market share from global leaders in non-Chinese markets.

Foreign Technology Acquisition Underpins "Made in China 2025"

At the heart of China's strategy is foreign technology acquisition. The Chinese leadership knows that if it just relies on market forces few if any foreign technology leaders will provide them with the technology Chinese firms need. Fewer would even establish factories in China, preferring instead to simply export products to China. As a result, China has deployed a panoply of tools to obtain needed foreign technology.

Intellectual property theft is one important tool in the Chinese arsenal. China has deployed industrial spies to obtain foreign secrets. As the *New York Times* documented, a leading Chinese computer chip maker allegedly paid employees of a Taiwanese chip company working with the U.S. company Micron to steal valuable chip designs.[6] Another vector is cyber theft. Seven percent of U.S. firms operating in China listed cyber theft as a problem, a number that presumably would be higher if every firm that had faced an intrusion was aware of it.[7] The *IP Commission Report on the Theft of U.S. Intellectual Property* found that China accounted for nearly 80 percent of all IP thefts from U.S.-headquartered organizations in 2013, amounting to an estimated $300 billion in lost business annually.[8] An updated 2017 Commission report put the figure at $600 billion.[9] Then NSA Director Keith Alexander has called Chinese IP theft, "the greatest transfer of wealth in history."[10]

Weak enforcement of IP law is another vector. Chinese firms can often copy and reengineer foreign technologies with impunity (what they call introducing, digesting, absorbing and re-innovating), even those technologies protected by patents. As a *MIT Sloan Management Review* article, "Protecting Intellectual Property in China," noted, "Intellectual property protection is the No. 1 challenge for multinational corporations operating in China."[11] According to the U.S. International Trade Commission, in 2009, U.S. IP-intensive enterprises conducting business in China reported losses of approximately $48.2 billion in sales, royalties, or license fees due to Chinese IPR infringement.[12] In 2018, according to the American Chamber of

Commerce in China, one-quarter of surveyed U.S. companies cited "Insufficient protection offered by text of IP-related laws and regulations," while 24 percent cited, "Difficulty prosecuting IP infringements in court or via administrative measures" as significant challenges.[13]

Another vector is to trick companies in the United States into thinking that a Chinese firm wants to invest in them. A seemingly independent Chinese investment fund will approach a small to mid-sized U.S. technology company and indicate a willingness to invest needed capital in the company. But before the Chinese company can do this, they must do due diligence and they send in employees, who turn out to work for a state-owned Chinese company) to obtain key information about the company, including trade secrets. The firm never hears back from the investment company again.

An increasingly important way for Chinese firms to gain access to needed technology is to simply buy up U.S. technology companies or invest in high-tech startups. Indeed, until recently, a not-insignificant share of Chinese foreign direct investment into the United States was in technology industries. According to Select USA, the top four industrial categories in terms of numbers of Chinese FDI projects from 2003 to 2015 were electronics, industrial machinery, software and information technology services, and communications.[14] The Rhodium Group reports that over the last 16 years there has been roughly $18 billion of Chinese FDI into ICT and electronics industries deals, with most of that in just the last few years. Of the $4.9 billion invested in electronics, $4.2 billion was invested in 2016, with 99.99 percent of that going to buy U.S. firms.[15] Of the $14.2 billion invested in ICT, 74 percent was made from 2014 to 2016, with more than 95 percent going to acquisitions.[16] These numbers would have been considerably larger if the federal government had not informally or formally blocked some deals through the Committee on Foreign Investment in the United States (CFIUS).

The main purpose of most Chinese technology companies buying U.S. technology companies is not to make a profit, but to take U.S. technology to upgrade their own technology capabilities. The Rhodium Group notes that in the aviation sector, "The dominant player is aviation conglomerate AVIC, which is looking to the US market to upgrade its technology and other capabilities."[17] Likewise, in the electronics and electrical equipment sector, "Chinese investors are drawn to the US electronics and electrical equipment sector for building their brands, expanding their sales and distribution channels, and upgrading their innovative capacity and technology portfolios."[18] Investments in pharmaceuticals and biotechnology are "often driven by upgrading technology (such as Wuxi's acquisition of AppTec, a laboratory services firm)."[19] As one study of Chinese FDI estimated, 30 percent of the private firm deals and 46 percent of the SOE deals are motivated by technology acquisition.[20] The authors go on to state that Chinese acquisition of overseas firms "has become the most widely used methods [of investing overseas] for Chinese firms, largely because it provides rapid access to proprietary technology."[21]

China has also ramped up its efforts to buy into early-stage U.S. technology start-ups. A recent report from DOD's Defense Innovation Unit Experimental (DIUx) finds that "Chinese participation in venture-backed startups is at a record level of 10-16% of all [U.S.] venture deals (2015-2017) and has grown quite rapidly in the past seven years."[22] And some of this investment comes from venture firms that are backed by Chinese governments (federal or provincial). For example, the Zhongguancun Development Group, a state-owned

enterprise headquartered in Beijing has set up "Danhua capital" to promote the strategy of "Zhongguancun capital going global and bringing in overseas advanced technology and talents."[23] Likewise, Shenzen Capital Group, a purportedly private venture capital firm that has invested in at least one advanced U.S. technology company,[24] has actually received about 80 percent of its invested capital from the Chinese government,[25] and its investments are focused, not surprisingly, to match the central governments key targeted industries. The firm even boasts a chart the compares the technology allocation of its investments and how it compares to the governments priorities.[26]

Forced Technology Transfer as a Key Weapon in the Chinese Arsenal

Dwarfing these tools is forced technology transfer. Although China's World Trade Organization (WTO) accession agreement contains rules constraining it from tying foreign direct investment or market access to requirements to transfer technology to the country,[27] China routinely requires firms to transfer technology in exchange for being granted the ability to invest, operate, or sell in China.[28] As Harvard Business School professors Thomas Hout and Pankaj Ghemawat document in "China vs the World: Whose Technology Is It?," Chinese technology transfer requirements as a condition of market access have affected scores of companies in industries as diverse as aviation, automotive, chemicals, renewable energy, and high-speed rail.[29] To be sure, because such conditions usually contravene China's WTO commitments, officials are careful not to put such requirements in writing, usually resorting to oral communications to pressure foreign firms to transfer technology.[30] In 2011, then-U.S. Treasury Secretary Timothy Geithner laid such concerns about China's technology transfer requirements, stating that "we're seeing China continue to be very, very aggressive in a strategy they started several decades ago, which goes like this: you want to sell to our country, we want you to come produce here. If you want to come produce here, you need to transfer your technology to us."[31] In 2012, 23 percent of the value of all foreign direct investment projects were joint ventures.[32] And the U.S.-China Business Council's "2014 China Business Environment Survey" reports that 62 percent of companies had concerns about transferring technology to China, while 20 percent reported that they had been requested to transfer technology to China within the past three years.[33]

Forced technology transfer is not new. A 1987 Congressional Office of Technology Assessment report states, "Although most U.S. firms approach the China market with the intent to sell products, many find they must include technology transfer if they wish to gain access to the China market."[34] But what is new are two things. First, there are more foreign companies seeking to get in the Chinese market, such that the scale of forced technology transfer is much larger than it was two decades ago. In 2015 for example, 6,000 new international joint ventures, amounting to $27.8 billion of FDI inflows, were established in China.[35]

Second, the sophistication and value of the technology the Chinese government is now demanding is significantly higher than in decades past when U.S. companies could afford to give their Chinese "partners" older generations of technology, confident that the U.S. firms could innovate faster. Now for many foreign advanced industry companies, doing business in China requires transferring ever-more valuable technology to Chinese joint venture partners. In 2013, 35 percent of U.S. business respondents in China said that tech transfer requirements were a concern, and 42 percent in advanced technology industries voiced this concern.[36] Fifty-six percent of survey respondents who gave a response thought that tech transfer requirements were

increasing.[37] And as USTR points out in its 301 report on China, it is likely that these numbers are under-reported.[38]

For example, the CEO of a large multinational telecommunications equipment company recently shared with ITIF that he opened up a large R&D facility in Beijing that employs over 500 scientists and engineers. When asked if he did this to access Chinese engineering talent, he responded bluntly: "Unless I promised the Chinese Government that I would open up an advanced technology lab there, I was told that I would not be able to sell to the Chinese telecommunications providers," (most of which are de facto controlled by the Chinese government).

The Chinese government has employed the weapon of forced technology transfer to gain technological know-how in a variety of industries. A well-known case in point concerns high-speed rail. Over the past 15 years China built the largest high-speed rail network in the world. That massive purchase of rolling stock, signal systems, and related equipment was something no foreign rail producer could afford to ignore. As such, the Chinese government had enormous leverage to pressure foreign producers to give the Chinese state-owned enterprise competitors key technology and IP. The Chinese term for this is "exchanging market for technology."[39] As Chen and Haynes document, in 2004 the State Council of China adopted a new railway development strategy that shifted from just subsidizing domestic producers in order to help them improve their technology to one where they "introduce advanced technology through joint design and manufacturing, [with an ultimate objective to] to build a Chinese brand."[40] After that the state Ministry of Railways (MOR) launched three tenders for foreign high-speed electric trains and in each one MOR stipulated that foreign companies had to collaborate with domestic partners in the competition and had to transfer key technologies to achieve localization.[16] The tender included two key conditions: to win, the bidder had to transfer technology to China and the final products had to marketed under the Chinese state-owned enterprise rail car brand. This was all in support of the government's "Action Plan for the Independent Innovation of Chinese High-Speed Trains." As a result, multiple foreign train companies were pressured to transfer valuable technology to the Chinese companies (now principally one company due to the central government forcing the two main companies to merge into a powerful national champion, Chinese Railway Construction Corporation, now the largest rail producer in the world.) As Chen and Haynes write, "The result is a new HSR [high speed rail] industry in China has emerged which now serves the new vast HSR network and looks externally to export its new skill in HSR production and its new cutting-edge activity in HSR innovations." Not only are CRCC and related Chinese companies virtually guaranteed all Chinese rail projects, but CRCC is now aggressively exporting trains and train systems containing advanced foreign technology to other nations, backed with generous export subsidies from the central government. For example, the China Export-Import Bank (a state agency) announced in 2017 the equivalent of $30 billion in financing assistance for CRCC exports.[41] (Surprisingly, the U.S. Department of Commerce International Trade Administration, in its document promoting U.S. rail export opportunities to China, makes no mention of the fact that the lion's share of these opportunities come with forced technology transfer requirements.[42])

The Chinese have employed different tactics to the same end in the biopharmaceutical industry, where various policies enable Chinese firms to get access to U.S. technology. For example, the relatively short six-year term for data exclusivity, coupled with the lack of a formal definition of a "new chemical entity," means

the Chinese government can pressure U.S. firms to turn over important data to Chinese generic drug firms. Similarly, the Chinese government requires that any drugs sold in China must go through Chinese clinical trials, even if they are approved in the United States. This extends the time for sales before a company can sell a drug by as much as 8 years, meaning that the company has only 12 years left of patent-protected sales in China before a Chinese generic company can copy the drug. Moreover, in China, unlike the United States and Europe, there is no extension of marketing exclusivity at the back end to take into account long clinical trial delays. Moreover, China also issues compulsory licenses for the intellectual property for particular drugs.[43] Finally, it presses foreign biopharmaceutical companies to form joint ventures if they want their drugs more easily put on the government list of drugs to qualify for reimbursement.[44]

We also see this in cloud computing. China requires companies running cloud-computing operations to be locally controlled. This means that if a company like Amazon Web Services or Microsoft wants to serve the rapidly growing Chinese market it must partner with a Chinese company and sell their services under the Chinese company brand. And as part of this partnership the expectation is that the foreign cloud provider will provide the Chinese firm with technology and know-how.[45] Chinese cloud providers, like Aliyun, the cloud services unit of Alibaba, is able to establish its own data centers in the United States without any similar requirements.

The Chinese have long had policies in place requiring joint ventures with local firms in order for foreign companies to produce automobiles in China.[46] And many of those production JV requirements also include joint R&D facility requirements. The government is now doubling down on this approach in order to be the global leader in electric vehicles. For example, Renault-Nissan and Ford Motor have established joint electric-car ventures in China.[47] Indeed, the New Energy Vehicles program under Made in China 2025 strategy requires foreign companies wishing to sell in China to disclose and share valuable technology with their local joint venture partner.[48] We see this pattern in many other advanced technology industries, including wind turbines.[49]

Tools to Force Technology Transfer

The Chinese have a host of tactics with which they use to pressure foreign companies to transfer technology. All involve "making them an offer they can't refuse." The first and most important is to set up industries that are off-limits to fully-owned foreign direct investment. China's "Catalogue of Industries for Foreign Direct Investment" classifies industries based on categories: "encouraged," "restricted," "prohibited." Other industries are considered to be "permitted." It is in the restricted category, (which includes 35 sectors, such as automobiles, commercial aircraft, and high-value added telecommunications services) that foreign firms are legally required to partner with a domestic firm in a joint venture.

China wields a host of other weapons to help foreign firms understand that it is in their interest to share their technology. One is to bring bogus anti-trust charges against foreign advanced industry companies and then as part of the settlement make it clear that they must transfer technology to local Chinese partners.[50] And with Chinese courts largely rubber-stamping the government's dictates, foreign companies have little choice but to comply. And, all too often, complying means changing their terms of business so that they sell to the Chinese

for less and/or transfer even more IP and technology to Chinese-owned companies, often after paying substantial fines to the government.[51]

Another tool is to force foreign companies operating in China to store data about Chinese users in China and turn over encryption keys and source code for inspection. Likewise, in some industries companies must disclose trade secrets as a precondition for receiving regulatory approvals for investments. Still another is to tie regulatory and licensing approvals needed for operation in China to technology transfer. Still another is to tie purchases by the state, including state-owned enterprises, to technology transfer. For example, the Commercial Aircraft Corporation of China (COMAC) requires foreign suppliers to enter into JVs with Chinese suppliers if they want to sell to COMAC.[52]

Forced Technology Transfer is Effective

Some apologists for Chinese coercion argue that China is shooting itself in the foot with these practices and that if we are just patient the Chinese government will see the error of its ways. Their argument is that by making it so painful for foreign firms to do business in China, the foreign firms will decide to participate less in China and not transfer any technology. Clearly this is naïve at best: The Chinese government is masterful at understanding the maximum amount of pain they can impose without the foreign firm balking.

Moreover, forced technology transfer has been an extremely successful strategy for helping China catch up technologically. One recent study published by the National Bureau of Economic Research examined all international joint ventures (JV) in China from 1998 to 2007. Between 1998 and 2012, they counted 4,057 U.S. JV's in China. First, they found that the Chinese firms the government chose to be partners of foreign investors were on average the best Chinese firms in the particular industry; they were larger, more productive, and more subsidized than other Chinese firms. Second, the Chinese JV partner firm gained substantial technological capabilities from its participation in the JV, even though foreign partners usually took steps to limit the transfer of technology to the partner. Third, it was not just the joint venture firm that benefited; so did many other Chinese firms in the same industry. As the authors write, there is a high level of "technology leakage" to other Chinese firms. This should not be a surprise because the Chinese government sees JVs a tool to upgrade entire Chinese industries, not just the designated champions. Fourth, the tech transfer effect is larger if the foreign firm is a U.S. firm compared to a Japanese or Taiwanese firm. This should not be surprising as in general U.S. firms are more focused on short-term returns (something they can get if they are more accommodating to the Chinese government and Chinese industrial partners) and also because there is more domestic government pressure of firms in Japan and Taiwan to not transfer valuable technology to China.[53] Finally, in contrast to what promoters of China's accession to the WTO might have hoped for, the amount of technology spillovers to other Chinese firms was actually higher after the Chinese joined the WTO than before.[54]

Other Steps to Gain Dominance

Once Chinese firms gain access to needed foreign technology, the next step of the Chinese strategy is to ensure that they have the capital needed to scale up. This involves direct and indirect subsidies and also designing markets protected from foreign competition, so the Chinese firms can accumulate capital. Once firms have the technology, competencies and scale to go global, the government often subsidizes global

market expansion, such as through the China Export-Import Bank (an entity the World Bank has funded) and China's Export and Credit Insurance Corporation (Sinosure).[55] Moreover, by leading to global overcapacity and selling below cost, China uses that overcapacity as a cudgel to disrupt the economics of innovation-based industries (i.e., subsidized competition prevents foreign competitors from earning reasonable profits from one generation of innovation to reinvest in future generations of innovation) and thus weaken foreign competitors, enabling Chinese firms to gain even more global market share.

The Chinese government also works to limit foreign competition for its budding national champions. For example, in the high-end equipment manufacturing sector, China maintains a program that conditions the receipt of a subsidy on an enterprise's use of at least 60 percent Chinese-made components when producing intelligent manufacturing equipment.[56] And despite the fact that China "clarified and underscored ... that it agreed that enterprises are free to base technology transfer decisions on business and market considerations" at a December 2014 meeting of the United States-China Joint Commission on Commerce and Trade (JCCT), USTR notes that China has "announced two measures relating to [local procurement of] information technology equipment used in the banking services sector and in providing Internet- or telecommunications-based services more generally."[57]

China also lavishes Chinese firms that have obtained foreign technology with massive subsidies. As George and Usha Haley document in their book, *Subsidies to Chinese Industry: State Capitalism, Business Strategy, and Trade Policy*, China's game plan has long been to "aggressively subsidize targeted industries to dominate global markets." As they document, in the 2000s, China provided almost $100 billion in subsidies to just three industries alone: $33 billion for paper, $28 billion for auto parts, and $27 billion for steel.[58] China's share of global solar panel exports grew from just 5 percent in the mid-2000s to 67 percent today, with Chinese solar output turbocharged by at least $42 billion of subsidies from 2010 to 2012 alone.[59] China now wants to replicate this strategy in other advanced-technology industries, such as semiconductors and electric batteries.[60] For instance, China's National Integrated Circuit (IC) Strategy calls for at least $160 billion in subsidies to create a completely closed-loop semiconductor industry in China, including explicit plans to halve Chinese imports of U.S.-manufactured semiconductors by 2025 and eliminate them entirely by 2035. The "Made in China 2025 Strategy" is supported by some 800 state-guided funds to the tune of more than $350 billion, including advanced-battery manufacturing, wide-body aircraft, and robotics.

China is Unique in Global Economic History

It is important understand how China differs from past Asian mercantilist nations. Japan and the four "Asian Tigers" (Hong Kong, Singapore, South Korea and Taiwan) all implemented mercantilist practices to leapfrog their industrialization process, including state subsidies, protected home markets, and other policies. But China is different in three fundamental ways.

First, these nations, especially Korea, Japan and Taiwan, largely closed their markets to U.S. firms, preferring to develop their own domestic champions. This reduced the leverage they had over U.S. firms to transfer their technology as a condition of market access. Moreover, it led U.S. companies to protest much more against these unfair practices since the competition was between "our companies" and "their companies." This explains why there was strong bipartisan support in Congress and the executive branch in the 1980s and early

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1990s for tough action against these practices and for robust domestic competitiveness policies. U.S. businesses strongly pushed for these policies.

In contrast, China took a different tact, welcoming in (some might say seducing) U.S. companies, but holding out access to the largest market in the world in exchange for what China wanted: advanced technology. Moreover, because so many U.S. firms are now ensconced in China and would be significantly hurt if they walked away, or if the Chinese government retaliated against them for U.S. government enforcement action, most have been less than full-throated supporters of tougher enforcement action against China.

Second, Japan and the tigers were largely "rule of law" nations. While the Japanese government, for example, could exercise considerable discretion through so-called "administrative guidance," it did have a Constitution, a legislature (the Diet), and laws that courts would enforce. This meant that not only were more of their mercantilist actions WTO-actionable, but there was a limit on how capricious and unfair the government could be. China knows no such bounds. For example, the Chinese government is too savvy and understanding of WTO legal arcana to ever put its rules on forced technology transfer in writing. It knows that if it did, this would be actionable under WTO rules. Rather, its rules are informal—known to all, but "hidden" behind face-to-face meetings and vague but ultimately clear informal messages. Moreover, when the Chinese government wants to send a message to a U.S. firm doing business in China—either to retaliate for some legitimate action the U.S. government has taken vis-à-vis China or simply to require a U.S. firm to toe the party line—it can pretty much do whatever it wants, including generating a trumped up anti-trust charge, denying permits and approvals, or otherwise making life difficult for a U.S. company.

Finally, Japan and the Tigers were not only allies of the United States, they benefited from and required the U.S. security umbrella. Without U.S. protection, these nations would have to cope with military and other security challenges from China, North Korea, and Russia on their own. As such, that gave the U.S. government some leverage to challenge their more egregious policies and practices. Moreover, the technological rise of these nations never posed a military and national security threat to the United States. In fact, an increase in their economic and technological strength benefited U.S. national security. The exact opposite is the case with China, which is working vigorously to upgrade its military capabilities to be on par, if not ahead, of the United States.

What is at Stake?

Given China's Made in China 2025 plan, it is no exaggeration to suggest that, without aggressive action, the United States may face a world within two decades where U.S. jobs in industries as diverse as semiconductors, computers, biopharmaceuticals, aerospace, Internet, digital media, and automobiles are significantly reduced due to Chinese policies unabashedly targeting domestic and global market share in those industries.

It is important to understand that the challenge to America's leadership in technology-based industries is much different than the process of losing more commodity-based, low-skilled industries to China in the 2000s. If, for example, the value of the dollar was to fall significantly related to the yuan (and other currencies), it is possible that America could regain at least some of the production lost to China in industries

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like textiles and apparel, furniture, metal parts, and other similar low- and medium-value added products. Companies could simply buy machines, set up factories, and restart production domestically in a cost-effective way. But if America's technology companies were severely weakened or even put out business, no currency decline could bring them back because competitiveness in technology industries is based less on cost and more on a complex array of competencies at the firm- and ecosystem-level. For example, a firm cannot simply buy some semiconductor equipment and start producing chips. To do that would require not just machines but deep and complex tacit knowledge embedded in the firm in workers (from the shop floor to scientists to managers) coupled with an innovation ecosystem (universities training the right talent, a network of suppliers, etc.). Once those capabilities are lost, they are essentially gone, and are very difficult to resurrect absent massive government intervention.

There is an additional reason why losing advanced technology industries is problematic. Most technology-based industries have high barriers to entry. In contrast to the t-shirt industry where entry largely requires just capital to buy sewing machines, entry into innovation-based industries requires both physical and intellectual capital. In an industry like semiconductors, for example, firms spend hundreds of millions, if not billions, of dollars developing technical capabilities to enable production. Producing the first chip of a particular generation is incredibly expensive because of the amount of R&D involved. Producing the second chip is much cheaper because only the material and labor costs are involved. In this sense, fixed costs are extremely high, but marginal costs are low. In these innovation-based industries losing market share to unfairly competing firms supported by their innovation mercantilist governments means two things. First, sales fall. This is true because global sales are largely fixed (there is only so much demand for semiconductors, jet airplanes, and other similar advanced products), and if a mercantilist-supported competitor gains market share, the market-based competitor loses share. Second, because profits decline more than sales, it is now more difficult for the market-based innovator to reinvest revenues in the next generation of products or services, meaning that the mercantilist-supported entrant has an advantage in the next generation of products. This can lead to a death spiral whereby the market-based leader can lose complete market share.

A loss of advanced technology industries has two major negative impacts on the U.S. economy. The first is on prosperity, as the average wage in these industries is approximately 75 percent higher than average U.S. wages.[61] The second is on national security and the defense industrial base. U.S. defense superiority is based is in large part on technological superiority. Our service men and women go into any conflict with the advantage of fielding technologically superior weapons systems. But maintaining that advantage depends on the U.S. economy maintaining global technological superiority, not just in defense-specific technologies but in a wide array of dual-use technologies. To the extent the United States continues to lose technological capabilities to China, U.S. technological advantage in defense over China will diminish, if not evaporate, as U.S. capabilities whither and Chinese ones strengthen. It is certainly a highly risky proposition to assume that the United States can continue its weapons systems superiority over the Chinese if: 1) the Chinese continue to advance, largely through unfair, predatory practices at the pace they are; and 2) the United States loses a moderate to significant share of its advanced technology innovation and production capabilities. As ITIF wrote in 2014, "The United States defense system is still the most innovative in the world, but that leadership is not assured and is in danger of failing. This decline is not only impacting defense innovation and capabilities, but also overall commercial innovation and U.S. competitiveness."[62]

Why Action is Needed
Some have invoked the "willing-buyer, willing-seller" defense to describe the relationship between U.S. companies and their Chinese company partners, especially with regard to joint ventures and technology transfer. For example, in interview in China's *People's Daily*, Liu Chuntian, Professor of Law School of Renmin University of China, argues, "the transfer of technology from American companies to China is a normal business practice. It is the result of two-way choice and independent decision-making by enterprises. It cannot be regarded as a mandatory behavior of government procurement." [63]

There are indeed some cases where the U.S. company is willing and engages in partnerships under no duress. But in most cases, foreign companies have little real choice between doing at least some of what the Chinese government wants and leaving the market. A survey of companies conducted by the EU found that only 12 percent of respondents would have chosen their current JV structure in the absence of JV requirements.[64] As Prud'homme writes, "Foreign firms are allowed some flexibility to decide whether or not they want to comply with China's FTT [forced technology transfer] policies. Yet all are accompanied by consequences for non-compliance."[65] And as Hout and Ghemawat note, "Executives working for multinational companies in China privately acknowledge that making official complaints or filing lawsuits usually does little good."[66]

There is another challenge that relates to market failures. One challenges is that for many U.S. firms the negative consequences from sharing technology won't accrue to the firm for five or ten years, while the negative consequences of not sharing technology are immediate. Given that the median tenure for a CEO at a U.S. large cap company is just five years, the rational decision for a typical CEO is to avoid the short-term pain, even if it means longer-term damage to the company.[67] The CEO will likely be gone by the time the damage is done. In the short run they get to continue to participate in the Chinese market with minimal hassle from the government. They effectively get co-opted.

A second market failure relates to spillovers. Sometimes U.S. firms share technology with Chinese firms that is not very important to them but is important to its other U.S. competitors. If a U.S. company has only a small share of the U.S. market in a particular technology, it is often willing to share that technology with its Chinese partner, knowing that this will do little to hurt its core business, but might hurt its other U.S. competitors, all the while buying goodwill with the Chinese government. Often China is able to succeed at this by focusing on second-tier players in any particular industry segment which, as McKinsey notes, "have less to lose than global giants—and everything to gain."[68] The problem, of course, is that the U.S. company's actions harm other U.S. companies that are still competitive in that particular technology.

Why the U.S. Government Is Justified in Pushing Back Against Chinese Innovation Mercantilism Broadly, and Forced Technology Transfer Specifically
The Chinese government defends these predatory practices on the grounds that as a sovereign nation it has the right to build its own advanced industries. The state-run *Global Times* newspaper wrote that it's "our sovereign right to develop high-tech industry and it is connected to the quality of rejuvenation of the Chinese nation. It will not be abandoned due to external pressure."[69]

It is China's sovereign right to do so the way they are doing it: as long as they are not members of the World Trade Organization. But when China joined the WTO it made a binding set of commitments to live by that at least in the spirit, if not the letter, of the law made these practices a violation of that commitment.[70] So if China insists on its right to practice predatory practices with impunity, it should withdraw from the WTO.

Others argue that China is justified in its practices because it faces pressures to modernize. As an article from Australia's Lowy Institute writes, "what is not negotiable for China is relinquishing the ambition of becoming a global leader in advanced technology industries. That is central to its economic progress as Chinese wages rise, the workforce begins to contract, and its labour-intensive manufacturing moves to other countries."[71] Likewise, a Council on Foreign Relations blog states that China's "ambition makes sense within the context of China's development trajectory: countries typically aim to transition away from labor-intensive industries and climb the value-added chain as wages rise, lest they fall into the so-called 'middle-income trap.'"[72]

But these views are wrong on two grounds. First, as the McKinsey Global Institute report *How to Compete and Grow: A Sector Guide to Policy* shows, per-capita income growth is overwhelmingly related to the ability to raise productivity in all industries, and not from changing an economy's industrial mix toward higher value-added industries.[73] Moreover, the so-called middle income trap is largely a myth.[74] Developing nations are not consigned to this trap; they can get out of it by raising productivity across the board in all industries.

Second, even if China wants to grow its technology economy, the key problem is the way in which they are going about it. The major problem with Made in China 2025 is the vast panoply of illegal, unethical, and unfair means China employs to reach its goals, which damage not only U.S. firms and workers, but the global innovation economy.

Limits of the WTO

One major barrier to getting China to roll back its predatory practices is that the World Trade Organization is not designed to deal with nations like China. The entire WTO framework, including its dispute settlement process, is premised on governments abiding by the rule of law and there being a fundamental separation between the state and the private sector. Neither is true in China. If something is in a law that is problematic, the WTO can rule against it. But that is not how China works and the Chinese are extremely canny on designing measures that can avoid triggering successful WTO challenges. As Harvard Law Professor Mark Wu notes, the lines between what is public and private in China blur, at least from a WTO perspective. He goes on to ask, "These scenarios remain complicated. Would SASAC's ability to remove the firm's top management or the NDRC's coordination on sector-specific policy suffice to render the firm a "public body?" For example, in China private banks often provide subsidies to an exporter because of informal demands from the government. As Wu writes, "At the heart of this challenge is the fact that China's economic structure is sui generis, having evolved in a manner largely unforeseen by those negotiating WTO treaty law.[75]

Second, also another problem is that given the WTO's limited capacity, it can realistically handle only about two-dozen major trade dispute cases annually, meaning China can flood the zone with a gauntlet of unfair practices that could simply never get adequately adjudicated under WTO auspices.

Finally, the U.S. government relies on firms to provide specific evidence of the unfair policies and harms. But U.S. firms know that if they cooperate with the USTR in a case against China they will face retaliation. As one corporate counsel related to me, representatives from their company met with the minister of a Chinese agency to complain about an egregious and predatory action from the Chinese government and warned that if this did not stop that the firm would go to USTR to imitate a WTO case. The minister told the company representatives that they certainly had every right to do that, but that if they did that they would never sell another product in China again. Needless to say, the U.S. company "turned the other cheek" and did not initiate the case.

This is not to say that more cases could not be effectively brought before the WTO, but there should be no illusion that as an institution that WTO can do more than push back at the margin. As such USTR should develop WTO "non-violation nullification and impairment" claims that would assert the United States is being denied the benefits of reasonably expected market access. The claims can contend that China's manifold mercantilist policies undercut and undermine the benefits and rights the United States thought it was getting when it assented to China joining the WTO. If that fails to produce satisfactory results, ultimately, the United States with its allies should consider establishing an alternative organization that can and will do the job. Nations that are governed by the rule of law and which do not put predatory practices at the center of their economic strategies would be welcomed to join. Others would be excluded, at least until they reformed enough to comply.

What the U.S. Federal Government Should Do

The main approach now being tried is tariffs under Section 301 authority. The Trump administration has announced placed tariffs on Chinese exports (including products ranging from aircraft to chicken incubators) and has announced his intention to add to that, But it is not clear what the administration's strategic goal is. Is it to reduce the trade deficit with China? Is it to restore production in traditional sectors, such as steel and autos? Or is it to pressure China to roll back egregious "2025" practices that threaten America's advanced industries? In our view, the goal should be the latter.

Regardless, any effective campaign to roll back Chinese innovation mercantilism will require a concerted joint campaign with our allies. The United States should be doing much more to develop such a coordinated agenda with like-minded allies.

In any case, the U.S. government can and should take a number of steps on its own. And there are steps Congress could take to help roll back Chinese innovation mercantilism. The first relates to boosting the institutional capacity of the federal government to understand and address these issues. The House should introduce and pass a companion to the National Economic Security Strategy Act of 2018 (S 2757). By requiring the administration to develop a national economic strategy to support the national security strategy, the legislation will not only help the administration make stronger connections between economic security and national security, it will help identify challenges and policy needs. By focusing attention not only on the strengths and weaknesses within American industry related to national security broadly defined, but also on the threats from other nations, policymakers will be better prepared to take the decisive steps that are required. ITIF has also published a list of proposals for legislative and administrative actions that would help

with trade enforcement.[76] Congress should also pass the Foreign Investment Risk Review Modernization Act (FIRRMA), to modernize CFIUS. It should instruct USTR to bring a WTO case against China over its ongoing failure to publish thousands of trade-related final measures, including subsidies, in a single official journal as it's required to do under WTO rules. One reason it's been difficult to bring subsidy cases against China at the WTO is that China fails to properly publish its subsidies. Getting the WTO to enforce China's publication requirements would make it possible to bring additional WTO cases for subsidy or other violations, such as forced IP or technology transfer.

The United States also needs a new regime to contest China's strict technology-licensing laws. Under Chinese contract law and technology import-export regulations (or TIER), a foreign licensor into China is obligated to offer an indemnity against third-party infringement to the Chinese licensee.[77] In other words, a foreign licensor licensing into China has to provide insurance that practicing the licensed technology does not infringe any IP held by a third party. But, under TIER, this legal obligation only attaches to "technology import contracts." That is, this obligation only attaches to a foreigner licensing technologies into China; the Chinese licensor has no such obligation. This discriminates against foreign licensors. The foreign licensor is legally bound to offer something that the Chinese licensee is not, making it difficult for small companies, companies which may experience high litigation risks in China's litigious environment, and companies engaged in collaborative research and development (such as cross-licensing, open-source licensing, and charitable activities) to arrive at mutually beneficial licensing agreements. TIER makes it almost impossible for small companies, such as start-ups, to license their breakthrough technologies in China, because no start-ups (due to their limited resources) would be able to conduct the complex analysis required by China's high-litigation environment and industrial policies that limit the value of foreign IP in order to offer insurance against third-party infringement disputes. While large multinational companies could avoid this issue by licensing technology (e.g., through their China-based subsidiaries), start-up companies cannot do so because they typically do not have subsidiaries in China. Consequently, the impact of the mandatory indemnification requirement on small- and medium-sized companies, and especially start-ups, is particularly acute.

Another provision in TIER mandates that in technology-import contracts, improvements belong to the party making the improvements, which typically is the Chinese licensee. Thus, foreign licensors, including U.S. firms, cannot negotiate to own any improvements or to share the improvements with Chinese licensees, even if both licensing parties desire for the improvements to be shared or owned by the foreign licensors. Moreover, TIER prohibits any technology-import contracts to "unreasonably restrict the export channels" of the Chinese licensee, thereby impeding the ability of the two licensing parties to allocate markets as they see mutually beneficial. Put simply, U.S. companies are obligated under TIER to let Chinese firms own the improvements and cannot freely negotiate with Chinese entities.

To address this discrimination, Congress should enact a regime whereby if Chinese entities seek licenses in the United States, then the Chinese enterprise must license on the same terms by which foreigners are required to license into China. Such legislation would specifically require the Chinese licensor to offer an indemnity against infringement by the U.S. licensee and to stipulate that the U.S. licensees are entitled to own the improvements they make and receive a reasonable market allocation under the licenses. Another possible approach would be for Congress to pass legislation requiring that the U.S. company whose original

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technology was improved by the Chinese entity receives an automatic exclusive license to use that improved technology [in the United States], such that the full potential of the original technology owned by the U.S. companies is not encumbered by improvements owned by the Chinese entity. Although technology-licensing law is usually a matter of state contract law, the legislation would be enacted pursuant to Congress's power to legislate international commerce.

There are other ideas that are at least worth considering and developing further. The United States could limit Chinese student visas to the United States. It could limit ongoing science and technology cooperation with China. The administration could take a hard line on limiting most Chinese investment in the United States, including in Chinese-backed tech accelerators.[78] It could prohibit Chinese firms that are stealing IP from accessing the U.S. banking and financial system. It could deny Chinese-headquartered enterprises access to listing on U.S. stock exchanges if they fail to provide financial statements in line with generally accepted accounting principles. It could build an "inspection wall" against counterfeit and pirated Chinese goods, with the goal of stopping them all. China accounts for 87 percent of counterfeit goods seized each year, with costs estimated to be between $30 and $40 billion.[79] These kinds of steps could be employed to gain more leverage in negotiations to roll back some of China's most egregious innovation mercantilist actions, including forced technology transfer and massive subsidies.

The federal government should also work to establish a deeper North American supply chain, as at least somewhat of an alternative to the Chinese supply chain. This would entail e maintaining (if not improving) NAFTA and expanding it to other Latin American nations.

It should also consider ramping up the use of anti-trust policies to discipline Chinese actions. Unfortunately, our antitrust regime is like the WTO: it is premised on the view that it is private companies that are in the driver's seat and call the shots, not sovereign nations. For example, China has abused the doctrine of "foreign sovereign compulsion" to justify anticompetitive behavior that has harmed U.S. interests, even though it initially passed muster in U.S. courts. In 2016 the U.S. Second Court of Federal Appeals threw out a case against Chinese vitamin C makers alleged to have conspired to fix prices and limit supplies in international markets, including in the United States, on grounds that the behavior was directed by the Chinese government and thus wasn't actionable under U.S. antitrust law because deference must be given to the official policies of foreign governments (i.e., the foreign sovereign compulsion defense). While this verdict was recently reversed by the U.S. Supreme Court, Congress should curb foreign governments' ability to abuse the foreign sovereign compulsion defense for these kinds of mercantilist ends.[80] One way to do so would be to require courts to give consideration to the implications for U.S. industries' global competitiveness in cases involving the foreign sovereign compulsion defense.[81] Congress should also call on the administration to eliminate a regulation that exempts mergers involving Chinese state-owned enterprises from having to be announced in accordance with U.S. antitrust law.[82]

Congress should also pass legislation that would allow firms to ask the Department of Justice for an exemption to coordinate actions regarding technology transfer and investment to other nations. One of the key levers China has is that it's a monopsonist: its market is so large it can pressure foreign companies to hand over technology in order to sell their products in China. But if companies in similar industries can jointly

agree that none of them will transfer technology to China to gain market access, then the Chinese government will have less leverage over them. The same would be true if companies agreed that they would not invest in China until China improved its IP protections. Such an amendment to antitrust law would be similar to the 1984 Cooperative R&D Act, which allowed firms to apply to form pre-competitive R&D consortia.

Congress should consider going even further to stand up a new arm of DOJ's antitrust division focused on foreign government-enabled and led antitrust violations. Currently, DOJ can bring actions against foreign firms if they are found to be acting in an anticompetitive manner. DOJ needs to not only be able to but be willing to bring actions against foreign firms if their actions are helped by their state in a way that leads to anticompetitive results. In the case of China, its subsidies, forced technology transfer, IP theft, and other unfair actions give Chinese firms unfair advantages that distort markets in an anticompetitive manner. DOJ should be able to investigate cases and if they found a violation, bring those to an administrative law judge who would adjudicate the case and the damages the U.S. government could impose on the Chinese companies that benefited from the anti-competitive Chinese government policies or practices. The challenge will be that not all Chinese companies likely to have cases brought against them are involved in the U.S. market. But some are, and for the ones that aren't such a ruling would effectively preclude them from entering the U.S. market.

In summary, taking firm and strategic action against Chinese predatory, mercantilist practices is long overdue. Whether such action can be successful is an open question, given the limits of the WTO, the unwillingness of the administration to engage our allies in the fight (and often their reluctance to be in the fight), and the fact that our leverage over China is much less than it was a decade ago. But one thing is clear: not taking action will make it much easier for the Chinese government to achieve their goal of dominating globally advanced technology industries.

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CSIS | CENTER FOR STRATEGIC & INTERNATIONAL STUDIES

Statement Before the

House Committee on Foreign Affairs

Subcommittees on Asia and the Pacific and Terrorism, Nonproliferation and Trade

"China's Predatory Trade and Investment Strategy"

Testimony:

William Alan Reinsch

Senior Adviser and Scholl Chair in International Business, Center for Strategic and International Studies

July 11, 2018

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Thank you for the opportunity to appear before you today. I want to begin by making clear the views I am presenting are my own and not those of either CSIS or Kelley, Drye & Warren. China's economic strategy is well-known. The Foreign Affairs Committee has discussed it in previous hearings, and the administration has documented it in its Section 301 report. Rather than repeat that material, I will spend my time discussing what the United States might do about it. I begin with a fundamental principle: if a country has an adversary and wants to stay ahead of him, there are only two ways: hold him back or run faster. Both strategies have their limitations, which is why the best approach is to pursue both. Let me take them one at a time.

Holding him back means denying him the means of gaining advantage, if possible, while trying to leverage better behavior. This has been the focus of the administration's efforts thus far, and it remains to be seen how successful it will be. We are attempting to deny China advantage through investment controls and export controls, both designed to impede the flow of critical technology beyond our borders. Congress has recognized that the current CFIUS process does not subject enough transactions to review and has moved to expand its reach. Both versions now in conference are thoughtful and carefully drafted. The administration has expressed its support for the legislation, and I agree that its enactment would be a positive step.

Similarly, your committee has reported and the House has passed legislation to reauthorize the Export Administration Act. That is long overdue, as you know, and its enactment would also be a useful step. I would, however, caution the committee against a too-broad expansion of controls. Maintaining control over the crown jewels of our economy is important. Attempting to re-control technologies that have already been released, are not critical, and are available from multiple sources would accomplish nothing and would do serious harm to our exporters.
In addition to investment review and export licensing, devoting more resources to compliance and enforcement is critical. The problem is not with large, established companies which know the rules and devote considerable resources to comply with them. Rather I worry about the small start up -- the proverbial two guys in a garage with a brilliant idea. When a savvy Chinese investor offers them $100 million for their company, they may not know -- or care -- that such a transaction would require CFIUS review or that any technology transfer pursuant to it could require an export license. The government does not currently do an adequate job of finding and monitoring those situations and making sure innovators know what their responsibilities are.

Leveraging better behavior is more complicated. As the president has said, the Chinese are doing what is good for them. Persuading them to do what is not good for them is a heavy lift. Nevertheless, there are some areas where agreement ought to be possible. The Chinese have in the past promised to end commercial IP theft, and there is no reason they couldn't do that again -- and actually mean it. It is a serious domestic problem in China -- most of the current IP litigation is between Chinese companies -- and very much in the government's interest to crack down on it if it wants to keep its own innovators from leaving. Similarly, discrimination against foreign companies in China based on corruption -- for example, the Chinese competing company gets favorable treatment because it is owned by the provincial Party secretary's nephew -- is something the government is already trying to stop.

The most difficult problem to address is *Made in China 2025.* Here we are asking China to restructure its economy into a market-based system and effectively abandon its technology

competitiveness goals. Doing that would reduce the Party's control of the economy and the society, which is the last thing they will be willing to do. Many of the technologies at issue involve aspects of the digital economy. For China these are not trade issues; they are national security and public control issues, and they are not susceptible to resolution in a trade negotiation. The president is attempting to force changes through tariffs. That is not likely to succeed for the reason I have indicated -- we are demanding that the Chinese do something that will imperil the Party's control – and it will certainly produce a great deal of collateral damage in its wake.

A better approach is through building coalitions. We have learned over the years that the Chinese do not like to be outliers. They do not like to be singled out as rules violators. When we have been able to get other major nations -- the Europeans, Japanese, Koreans, Indians, Australians and so on all conveying the same message at the same time at a high level we have had some success. So far, the administration has not shown much interest in this approach. I would also suggest that a more productive course would be to recognize that the long-term battleground is not in China but in the United States and in third countries where the playing field is level. We can deny them advantages here and in the process give a boost to our own manufacturers and innovators. In third countries we can not only compete with the Chinese on more equal terms, we can also develop networks of rules and standards that work to the advantage of Western economies. That is what TPP was really about, and it is what TTIP is about -- building trading structures based on Western rule of law principles and standards to which the Chinese will ultimately have to conform if they want to access the very large market structures and global supply chains we have created.

Beyond trade negotiations our government can also help Americans compete more effectively through more aggressive use of time-tested tactics: letting the Export-Import Bank function as intended, using trade missions to promote American products, and aggressively defending American commercial interests in third countries. The single data point I hope you will remember is that 95% of the world's consumers are outside the United States. Maintaining a competitive advantage over China inevitably means beating them in third countries. If we cannot do that, we ultimately marginalize ourselves and yield leadership to China.

Finally, let me say a few words about running faster. Although it is not my primary topic today, it is more important. The reality is that holding the other guy back doesn't work all that well. There are simply too many ways to get around the steps we take. Plus, there are inevitable limitations on what we can do to control someone else's economic policy. The one thing we can control is our own economic policy, and if we do it well, we can surmount the Chinese challenge. In today's globally integrated economy, that means more than pro-growth macroeconomic policies and more than job creation. In the past I have suggested a competitiveness tripod:

1) Train our workforce for the demands of the 21st century economy through more effective adjustment assistance programs and education policies that help future workers be more agile and acquire the skills necessary in a digital economy.

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2) Give our companies incentives to stay here. In my fifteen years representing large companies at the National Foreign Trade Council I learned you can't bludgeon them into submission but you can incentivize them into better behavior.

3) Promote innovation. This is something we have always been good at. Beginning in the Lincoln Administration, the United States has a long history of successfully mobilizing public support and resources to meet national priorities. World-class agriculture, wireless communications, aerospace and the Internet are good examples. Over the years we have shown ourselves to be very good at targeting government resources on innovation in the sectors that will define global leadership in the future. This is what the Chinese intend to do, and we should remember that we thought of it first and can do it better -- not with the massive WTO-illegal subsidies they plan to use, but with expanded support for basic research, encouragement for our private innovators, and immigration policies that encourage smart people to study -- and stay -- here.

These can be debated, and I know my colleague Rob Atkinson has a more detailed plan, but the principle of running faster remains fundamental. A strategy based solely on trying to hold China back will not succeed.

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1. Amid trade war talk, an unresolved issue: How to get China to play fair?

For a seemingly dry subject, trade policy seems to resonate with Americans. Perhaps competitive disadvantage is intuitive. The idea of a trade war instills fears, but unfair practices breed resentment.

– Noelle

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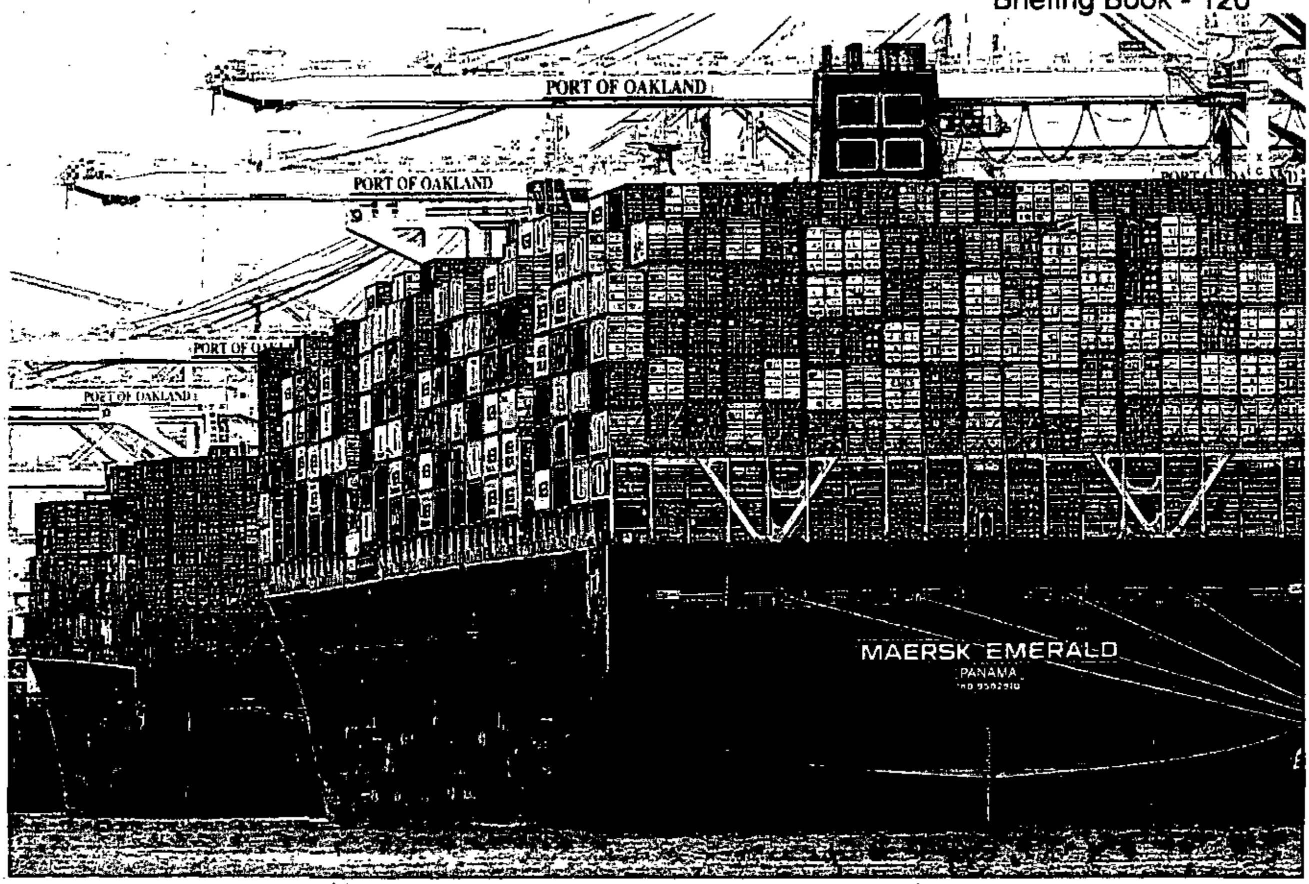

The container ship Maersk Emerald is unloaded at the Port of Oakland (Calif.) Thursday, July 12, 2018. President Trump is offering assurances that the US will 'ultimately' work out a 'pretty nasty trade battle' with China.

Caption | Ben Margot/AP

TWO WAYS TO READ THE STORY

QUICK READ **DEEP READ** (4 MIN.)

By Mark Trumbull, Staff writer
@MarkTCSM

WASHINGTON

In news coverage of global tensions over trade, a dominant message has been one of growing concern over the damage that tit-for-tat tariffs would do to the global economy.

The worries are well founded – with forecasts ranging from rising consumer prices to falling exports and sagging economic growth. Tariffs have already resulted in layoffs at some US manufacturers. At others, supply chains have been disrupted, according to anecdotes in a Federal Reserve survey of businesses released Wednesday.

Yet, even as Republicans in Congress weigh a rare legislative effort to rein in one of President Trump's policies, something important has been largely pushed out of the spotlight: that US experts widely agree that China is using unfair trade practices in ways that harm both the US economy and the goal of a rules-based system for global trade.

Jennifer Hillman, who has served on the World Trade Organization's appellate body, lists a host of Chinese practices that run counter to the values on which the WTO was founded: heavy use of subsidies, theft of intellectual property or trade secrets, and requirements that US firms transfer technology to Chinese partners as a precondition of doing business in China.

But for more than a decade, it has proved hard to build a consensus – within the US or with global allies – on how to challenge China effectively. And although the Trump administration is trying to change that, its simultaneous focus on smaller trade disputes with Europe, Canada, and Mexico have created a distraction.

"There has been a losing sight of the real problems with China," says Ms. Hillman, who now teaches at Georgetown University's Law Center. "China didn't do what it promised to do when it joined the WTO, which was to become a more market economy."

No one disputes China's right to develop its own economy, but what's in doubt is the long-held hope among Western nations that the ruling Communist Party would, after joining the WTO, abide increasingly by the norms of Western market-based economies.

"The entire WTO framework, including its dispute settlement process, is premised on governments abiding by the rule of law and there being a fundamental separation between the state and the private sector. Neither is true in China," Washington-based trade expert Rob Atkinson said in testimony to a House committee last week.

Bipartisan moves in Congress

For now, though, some influential forces in the US are focused on countering Trump administration policies. The US Chamber of Commerce has launched an advertising campaign opposing tariffs.

And bipartisan efforts in Congress could result in legislation designed to stop an escalation of trade conflict. Sens. Lamar Alexander (R) of Tennessee and Doug Jones (D) of Alabama plan to introduce a bill next week to prevent new tariffs on foreign cars and auto parts. Both states have seen workers gain from growing automotive production.

Senator Alexander said Wednesday that "nothing could do more to damage those family incomes than the proposed tariffs on imported automobiles and automotive parts, combined with the tariffs on imported steel and aluminum that the administration has already imposed."

Meanwhile, another bill in the Senate would block the president from using a national-security rationale to impose new tariffs, unless Congress approves. This month the Senate also passed a nonbinding resolution, 88 to 11, implicitly questioning the administration's tariff moves.

In polls, Americans show concern about trade conflict but also about China. About 73 percent of Americans, in a late June Quinnipiac University poll, said a trade war would be bad for the economy. But the same polling group, earlier in the month, found that by a 52-to-36 percent margin, Americans favored putting tariffs on Chinese imports.

"In the Congress there's a sense that we need to do something with respect to China," says Scott Paul, president of the Alliance for American Manufacturing, a partnership of manufacturers and the United Steelworkers union. But the levels of concern differ, he says, and lawmakers have taken few firm steps to tackle the issues, such as a glut of Chinese steel on world markets.

"If you don't like the president's plan, what's the plan?" Mr. Paul wonders. "The mistake that Congress could make is pulling the rug from beneath the president's feet before we see the chance for this strategy to play out."

So far, it hasn't played out in a pretty fashion. US talks have at various times faltered with both China and more traditional trade partners. The tally of expected tariffs and countertariffs keeps rising.

Some bending on steel

At the same time, negotiations aren't over. And with the new US tariffs nudging it, Canada has announced efforts to curb transshipment of China-made steel, Paul notes.

This month, the European Commission has voiced interest in working with the US and others on WTO reforms, which might address America's process-related concerns about the body that hears trade-case appeals.

"It represents a very promising start," says Hillman at Georgetown, referring to the European overtures.

Frustrated with the WTO, the Trump administration has been blocking discussion of new appointments to the WTO's appellate body, which currently has only 4 of 7 members in place, she says.

Trade experts don't expect all issues to be resolved through the WTO, but they generally support efforts to preserve and use it as a global forum on trade. Hillman says the best hope of resolving disputes with China is for nations to join a broad-based WTO case against Beijing's practices, going well beyond past cases in scope.

For now, though, Trump and his trade team haven't appeared to set a clear path forward amid the smoke of tariff threats toward China and long-time allies alike. Not for coalition-building, at least. The hope appears to be that tariffs will make other nations buckle to US demands.

"It does not appear that there is any strategy to get at the long-term significant problems with China," Hillman says.

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Is Beijing going back to the future with its much-hyped 'Made in China 2025' plan?

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News › China › Economy
Orange Wang orange.wang@scmp.com

Washington has singled out the industrial strategy in its trade row but precedent points to trouble on the ground

When the eastern Chinese city of Huzhou announced the recipients of its "Made in China 2025" subsidies last year, one of the biggest winners was milk tea maker Xiangpiaopiao.

The company, best known for its ubiquitous instant drinks, walked away with 16.56 million yuan (US$2.49 million), or about 10 per cent of the city's funds for the scheme, to set up a new "smart" liquid milk tea factory.

Made in China 2025 is the central government's big plan to move China up the global value chain and establish it as the dominant force in the technologies of the future.

US tariffs take aim at Made in China 2025 plans in first salvoes of trade war [1]

Washington sees it as a well-defined, well-orchestrated strategy and seeks to undermine it with tariffs imposed late last week.

But Lu Jiun-wei, a deputy researcher with the Taiwan Institute of Economic Research, said using Made in China 2025 subsidies for milk tea production reflected an old patten of "there's a policy above, and there's a way below", meaning well-intended policy could be distorted during implementation.

"It is still an old model that Made in China 2025 has to face," Lu said.

The company, which is listed, declined to comment, and the Huzhou authority in charge of granting the subsidies did not reply to a request for comment.

Huzhou in Zhejiang province is one of dozens of cities Beijing has approved as pilot centres for the plan unveiled three years ago. The idea is to support innovative, green and advanced technology but analysts said that so far it was more of a broad vision than a concrete plan.

Beijing plays down 'Made in China 2025' as Trump escalates trade row [2]

Zhong Wei, a finance professor at Beijing Normal University, said the central government had made no arrangements for the plan in terms of personnel, budgets or resource allocation.

One more substantial part of the plan is the 51.61 billion yuan Beijing earmarked last year for local Made in China 2025 plans.

In their quest for those funds, many provincial and municipal authorities have dusted off their regional industrial development blueprints and rebranded the strategies and subsidies as Made in China 2025 ones, according to a report released online on May 30 by the National Manufacturing Strategy Advisory Committee, a body advising the government.

The report, co-authored by Huang Qunhui, head of the industrial economics institute under the Chinese Academy of Social Sciences, said most local government Made in China 2025 plans were simply existing regional industrial blueprints. They also focused too much on the need for "government guidance" and fiscal subsidies.

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The authors said the lack of overall coordination raised the danger of exacerbating a problem China is already grappling with – excess capacity.

"There is quite a big risk of duplicated development – the various governments overlap a lot in their key areas of development and it may lead to a new round of overcapacity," the report said.

Why Made in China 2025 shouldn't scare Donald Trump [3]

China's administration is well versed in the perils of overcapacity. In 2009 when the global financial crisis took the edge off the economy, Beijing launched a massive stimulus programme for 10 industries from steel to shipbuilding. The cash injections were effective in bolstering short-term growth but also resulted in excess capacity.

A similar wave of investment was unleashed in 2012 when the Chinese government officially listed seven sectors – including biotech and new-energy vehicles – as "emerging strategic industries". Subsidies were set aside for these areas but this time the problem was less about duplication and more about the long list of scandals associated with claims for the money.

Made in China 2025 also names 10 sectors – from robotics to biopharmaceuticals – to come in for special attention the country's overall goal of accelerating innovation and improving the quality of products and services.

Is it time Beijing ditched its 'Made in China 2025' strategy? [4]

And, as ever, the success of the plan will come down to implementation on the ground, according to Shang-Jin Wei, a former chief economist of the Asian Development Bank and now a finance professor at Columbia University.

"The history of such economic directives in China suggests that the authorities often miss the mark on many of these targets [because Beijing's] industrial subsidy policies are not particularly efficient," Wei wrote in a note on April 1.

According to the Organisation for Economic Cooperation and Development, China's basic research expenditure amounted to 0.1 per cent of gross domestic product in 2015, lower than the share of spending not only in the US but also Argentina and South Africa.

Topics: Made in China 2025
US-China trade war
US-China trade war: All stories
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POLITICO

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The $50 billion of Chinese goods on which President Donald Trump plans to slap 25 percent tariffs, starting on July 6, include items related to Made in China 2025, according to the White House. | Thomas Peter-Pool/Getty Images

Beijing tries to play down 'Made in China 2025' as Trump escalates trade hostilities

By SIDNEY LENG | SOUTH CHINA MORNING POST and ZHENG YANGPENG |SOUTH CHINA MORNING POST | 06/26/2018 10:08 AM EDT

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Beijing is attempting to play down "Made in China 2025" by ordering state media to minimize their coverage of the industrial modernization program, as President Donald Trump makes it a focus of his trade battle with China.

Three separate mainland media sources briefed about the directive told the South China Morning Post that the government has instructed Chinese state media agencies to avoid mentioning Made in China 2025 in their reports.

A reporter with a state-owned newspaper told the Post that an official affiliated with the Communist Youth League in Beijing recently made him aware of the demand.

Another source traced the clampdown back to early May, when an American delegation headed by U.S. Treasury Secretary Steven Mnuchin flew to Beijing to begin trade negotiations with a Chinese team led by Vice-Premier Liu He.

The sources declined to be named because instructions from Chinese censors are often regarded as confidential information.

At a press conference in Beijing on Tuesday, there was no mention of Made in China 2025 by officials from the Ministry of Science and Technology and the Ministry of Industry and Information Technology — even though their focus was a hi-tech "smart industry" exhibition in Chongqing.

When asked by the Post whether Beijing would withhold or adjust the controversial policy, industry and IT ministry chief economist Wang Xinzhe said arrangements were made at last year's party congress to upgrade the manufacturing industry. Without mentioning Made in China 2025 at all, Wang said the ministry was following guidelines set during the congress.

Made in China 2025, an ambitious plan to give the country a leading edge on several hi-tech fronts, has become a thorny issue between China and its trading partners, including the U.S. and the EU.

The plan aims to make China a tech superpower by calling for a dramatic increase in domestically made products in 10 sectors — from robotics to biopharmaceuticals — that the government hopes will accelerate an industrial upgrade as economic growth slows.

It seeks to advance the development of industries that in addition to semiconductors include artificial intelligence, pharmaceuticals and electric vehicles.

The $50 billion of Chinese goods on which Trump plans to slap 25 percent tariffs, starting on July 6, include items related to Made in China 2025, according to the White House.

TRADE
Trump's trade war triggers recession fears
By BEN WHITE

Trump also is attempting to impede Beijing's progress in its industrial development by blocking Chinese companies from investing in U.S. tech firms, The Wall Street Journal reported.

While U.S. media have boosted their efforts to explain the facts behind Made in China 2025 as the looming all-out trade war focuses attention on it, voices promoting the initiative in China's official rhetoric have grown significantly fainter.

Mentions of the program on the website of China's Ministry of Commerce have sharply fallen.

In the past 12 months, the ministry published close to 190 Made in China 2025 articles on its site, ranging from government documents that established national demonstration areas for the project, to promotional materials that lauded its benefits to the southern African country of Zambia.

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But in the last three months, the number of articles published on the site plunged to nine, with just two in the last 30 days.

The most recent piece, published on June 19, recirculated an April document from the State Council, China's cabinet, praising 14 Chinese cities for carrying out the program effectively last year.

FOREIGN POLICY

Pompeo gives U.S. diplomats 'dose of reality' after early high hopes

By NAHAL TOOSI

A quick search on the website of People's Daily, the mouthpiece of the Communist Party, turned up references to dozens of Made in China 2025 articles that were published or shared this month, but the sources were mainly local governments, rather than Beijing.

For instance, an article published by Changzhou Daily last week said that Changzhou, an industrial center in eastern Jiangsu province, took part in Made in China 2025 by speeding up its development of intelligent manufacturing — generally understood to mean deploying industrial robotics to enhance competitiveness.

Zhong Wei, a Beijing Normal University professor, has said that Beijing could play down the importance of Made in China 2025 if it wanted to ease other nations' growing concerns about China's global ambitions.

In an article published on his personal social media account this month, Zhong said Beijing should stop touting Made in China 2025 as a development strategy, which the US and Europe see as indisputable evidence of China's aim to dominate hi-tech sectors via state-sponsored activities.

The EU's business lobby, for example, has warned that China could use the plan to discriminate against foreign firms in favor of Chinese competitors.

Instead, Zhong said, Beijing should present the program as a simple guideline for upgrading its manufacturing sector.

"There is no evidence that Beijing has made any concrete arrangements for Made in China 2025 in terms of personnel, budgets or resource allocation," Zhong wrote.

"It is a visionary and guiding document, and is completely different from China's five-year plans on economic and social development."

Additional reporting by Amanda Lee

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COUNCIL on FOREIGN RELATIONS

Why Does Everyone Hate Made in China 2025?

China's grand plan to bolster hi-tech industries at home is not receiving much love abroad. There's a good reason why.

Blog Post *by* Guest Blogger for Adam Segal

March 28, 2018

A man walks past a billboard at 2017 China International Robot Show in Shanghai Reuters:Aly Song

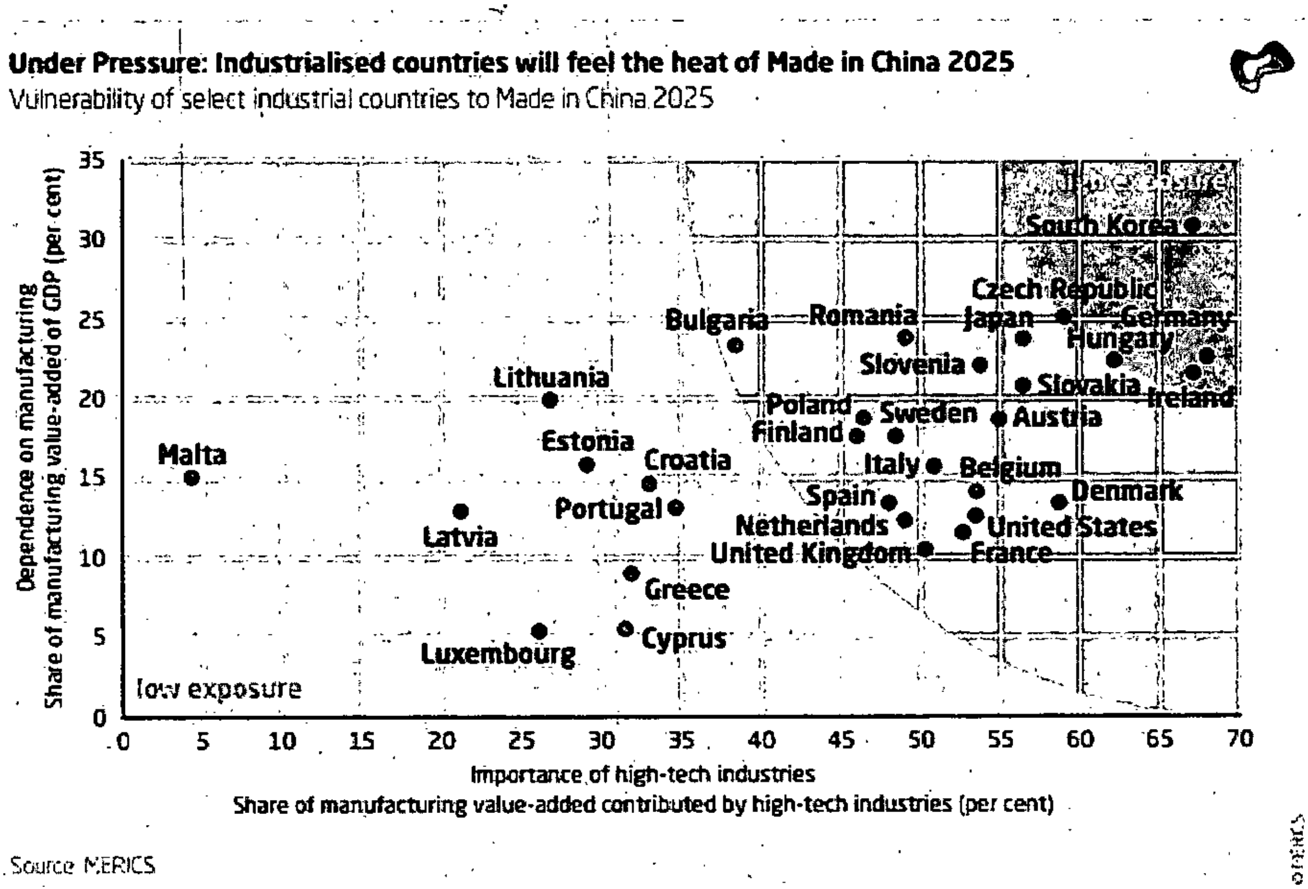
Lorand Laskai is a research associate in the Asia Studies Program at the Council on Foreign Relations. You can follow him @lorandlaskai.

On the same day that the Trump administration announced $60 billion in tariffs against China last week, the Office of the United States Trade Representative (USTR) dropped the results of its Section 301 investigation into China's unfair trade practices. The nearly 200-page report presents a searing indictment of China's disregard for intellectual property, discrimination against foreign firms, and use of preferential industrial policies to unfairly bolster Chinese firms. Interestingly, the report singles out one Chinese government initiative, in particular, as a prime example of Beijing's egregious behavior: Made in China 2025.

Made in China 2025, originally approved by China's State Council in 2015, is mentioned or cited an astounding hundred and sixteen times. In contrast, China's Cybersecurity Law, which has caused a perennial headache for many U.S. multinationals, is only mentioned thirteen times. And for good reason. Beijing's grand plan to upgrade its manufacturing base has riled governments around the world, confirming their suspicion that China is not looking for a 'win-win' in trade relations as its overseas emissaries often insist. In the saga of the U.S.-China economic rivalry, Made in China 2025 is shaping up to be the central villain, the real existential threat to U.S. technological leadership.

What is Made in China 2025? Made in China 2025 is a blueprint for Beijing's plan to transform the country into a hi-tech powerhouse that dominates advanced industries like robotics, advanced information technology, aviation, and new energy vehicles. The ambition makes sense within the context of China's development trajectory: countries typically aim to transition away from labor-intensive industries and climb the value-added chain as wages rise, lest they fall into the so-called "middle-income trap." Chinese policymakers have diligently studied the German concept "Industry 4.0," which shows how advanced technology like wireless sensors and robotics, when combined with the internet, can yield significant gains in productivity, efficiency, and precision.

However, China's intention through Made in China 2025 is not so much to join the ranks of hi-tech economies like Germany, the United States, South Korea, and Japan, as much as replace them altogether. Made in China 2025 calls for achieving "self-sufficiency" through technology substitution while becoming a "manufacturing superpower" that dominates the global market in critical high-tech industries. That could be a problem for countries that rely on exporting high-tech products or the global supply chain for high-tech components.



Which countries will feel the heat of Made in China 2025? The Mercator Institute for China Studies (MERICS)

What's wrong with China setting quotas for self-sufficiency? For one, such quotas violate WTO rules against technology substitution. Made in China 2025 lays out targets for achieving 70% "self-sufficiency" in core components and basic materials in industries like aerospace equipment and telecommunication equipment by 2025. That could devastate countries like South Korea and Germany, where hi-tech sectors constitute a large share of industrial output and exports.

The supply chains for hi-tech products usually span across many borders, with highly specialized components often produced in one country and modified or assembled somewhere else. Rather than abiding by the free market and rule-based trade, China is intent on subsuming the entire global hi-tech supply chain through subsidizing domestic industry and mercantilist

industrial policies. Semi-official documents lay out even more specific quotas for Chinese manufacturers. Officials at China's Ministry of Industry and Information Technology (MIIT) insist these targets are not official policy, though a report from the Mercator Institute for Chinese Studies argues that officials are using internal or semi-official documents to communicate targets to Chinese enterprises in order not to openly violate WTO rules.

How is Beijing acquiring advance technology for Made in China 2025? Equally problematic to Beijing's goal of "self-sufficiency" and becoming a "manufacturing superpower" is how it plans to achieve it. Chinese officials know that China lags behind in critical hi-tech sectors and hence are pushing a strategy of promoting foreign acquisitions, forced technology transfer agreements, and, in many cases, commercial cyber espionage to gain cutting-edge technologies and know-how.

While the Obama administration spent years pressuring Beijing to rein in commercial cyber espionage, Washington and other capitals are only beginning to grapple with the repercussions of Chinese investment and technology transfer agreements. Unlike cyber theft, neither is illegal per se. Surging Chinese investment in the United States and Europe have been a recurring story over the past few years. However, lawmakers are increasingly concerned that such investments, especially in high-tech sectors, are not just a product of market forces, but guided by Beijing as well.

Circumstantial evidence confirms this suspicion. Chinese investment in the United States and elsewhere, especially in hi-tech sectors, has skyrocketed since 2015. Often these investments evince a broader coordinated strategy. Take the example of Fujian Grand Chips, a purportedly private Chinese company that attempted to acquire German machine maker Aixtron in 2016. Shortly before it staged a public takeover of Aixtron, another Fujian-based company San'an Optoelectronics canceled a critical order from Aixtron on dubious grounds, sending its stock tumbling and presenting Fujian Grand Chips with an opportunity to swoop in. Both Fujian Grand Chip and San'an Optoelectronics shared a common investor: an important

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national semiconductor fund controlled by Beijing. The acquisition was stymied by an 11th-hour intervention by government officials but demonstrated how Beijing can drive investing abroad, often in a highly coordinated manner.

Technology transfer agreements and restrictive market practices in China present a similar problem. Foreign companies often enter agreements to transfer valuable intellectual property to Chinese partner in exchange for market access. These agreements can be exploitative and highlight the asymmetries in market access between China and the rest of the world. Speaking about Chinese takeovers of German firms, Germany's Economic Minister Sigmar Gabriel said Germany should not sacrifice "its companies on the altar of free markets" while China denies German firms equal access to invest in the Chinese market.

What can realistically be done? The keyword in Trump's recent tariffs against China is "reciprocity." That's the right approach. An Asia Society task force concluded last year the United States should urgently insist on reciprocity in the U.S.-China trade and investment relations, even if it adds tension to the relationship. However, a trade war, as Scott Kennedy points out, is no cakewalk, and it's unclear whether the administration has a clear idea of its desired end-game. Moreover, Trump is using a wrecking-ball when a more precise tool would have provided a better outcome. In addition to trade action against China, Trump has also announced a blanket tariff on foreign steel, which affects U.S. allies as well as China. While many allies have secured temporary exemptions to the tariff, Trump's pugilistic behavior is burning valuable goodwill. As Matthew P. Goodman and Ely Ratner argued in *Foreign Affairs*, many countries share Trump's desire to combat Chinese hi-tech mercantilism, but Trump is dividing allies rather than unifying them to confront China.

Instead, the administration should focus on the long-game of building a political consensus at home and abroad. That should include updating the Committee on Foreign Investment in the United States (CFIUS) to better vet Chinese investment into hi-tech sectors; using existing venues like the WTO to present a case against Chinese industrial policies; and rejoining the

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Trans-Pacific Partnership, which set high bars for intellectual property protection, labor standards, and safeguards against unfair competition from state-owned enterprises. Common sense investments at home should also be a priority. Investing in education, infrastructure, and basic science does not generate the same headlines as a trade war, but will do more to ensure the United States maintains its edge.

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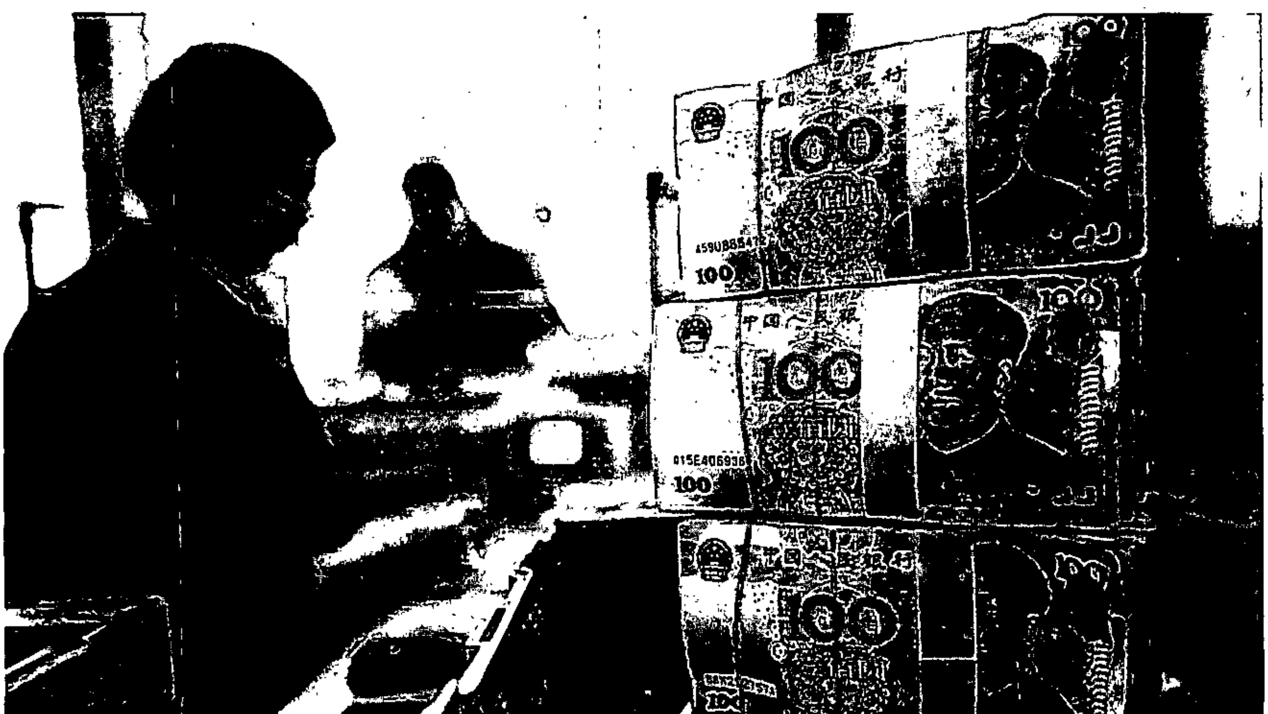
ASIA WORLD

How 'Made in China 2025' became the real threat in a trade war

By JESSICA MEYERS
APR 24, 2018 | BEIJING



An employee counts money at a bank in Lianyungang, in eastern China's Jiangsu province. In the event of a trade war with the United States, China could resort to devaluing its currency. (Ryan McMorrow / AFP/Getty Images)

China unveiled its plan to dominate the world's most crucial technologies with little international fanfare, another vague, guiding principle in the labyrinth of Communist Party bureaucracy.

Three years later, it's at the core of a trade dispute with Washington that threatens to upend the global economy.

Made in China 2025 is a blueprint for transforming the country from a labor-intensive economy that makes toys and clothes into one that engineers advanced products like robots and electric cars. The Trump administration views it as an attempt to steal U.S. technology and control cutting-edge industries.

Officials aimed to temper the initiative this month when they announced potential tariffs on $50 billion in goods. But Chinese leaders consider the plan key to the country's development and refuse to alter its course.

"China is trying to achieve a clear goal and America wants to stop it," said Andrew Polk, co-founder of Trivium/China, a Beijing research firm. "And that's where the competition is."

Here's what China 2025 is all about and what it means for the trade war:

What's the objective?

The plan funnels billions into 10 industries, everything from biopharmaceuticals to aerospace and telecom devices. It calls for 70% of related materials and parts to be made domestically within a decade. A separate document details China's strategy to lead in artificial intelligence by 2030.

Officials modeled Made in China after a German initiative called Industrie 4.0, which envisions greater automation in manufacturing and "intelligent factories" that operate with wireless sensors. They didn't have much choice. The world's biggest population is aging and rising wages are sending low-tech factories to other countries.

"The labor supply is decreasing," said Ashley Qian Wan, China economist for Bloomberg Economics in Beijing. "And that's going to be a big problem for China."

Why does China care about this so much?

When President Kennedy vowed in 1961 to send a man to the moon, more than 30 million people in China had just starved to death. People's Republic founder Mao Tse-tung closed universities for a decade while researchers invented the Internet in Silicon Valley. China sees itself as simply trying to catch up.

The country developed its first bullet train last year, a 248 mph vehicle named Fuxing, or rejuvenation. Engineers also built the country's first homegrown jetliner, an initial step toward filling Beijing's crowded airport with planes from China rather than America's Boeing or Europe's Airbus.

Officials portray the initiative as transparent and open to foreign companies. They dispel notions that it will monopolize domestic markets. America's dismissal of the plan reinforces a party narrative that the U.S. seeks to undermine China's resurgence.

"We have good reasons to question the legality and legitimacy of many actions taken by the U.S. on the grounds of national security, like its plan to impose high tariffs on many industries of Made in China 2025," Chinese Foreign Ministry spokeswoman Hua Chunying told reporters this month. "Clearly, they are targeting something else."

Why is the U.S. concerned about it?

The Trump administration frets about the way China aims to achieve its 2025 ambitions. American businesses have long complained about the sacrifices they make to operate in the world's largest market, including requirements to partner with domestic companies and hand over trade secrets.

Officials fear these techniques will make it impossible for U.S. companies to compete in the world's most critical fields. They also worry massive Chinese government subsidies will lead to a global glut of products that push down prices and hurt U.S. businesses.

"There are things China listed and said, 'We're going to take technology, spend several hundred billion dollars, and dominate the world,'" U.S. Trade Representative Robert Lighthizer told senators at a March hearing. "And these are things that if China dominates the world, it's bad for America."

A lengthy U.S. report on China's intellectual property theft — which led to the most recent potential tariffs — mentioned the plan more than 100 times. Officials are exploring multiple ways to restrict Chinese investment in key industries. The administration recently banned ZTE, China's second-largest maker of telecom equipment, from buying American technology.

"Consensus is growing in Washington that the U.S. is in a race with China for technical leadership," Arthur Kroeber, managing director of Beijing research firm Gavekal Dragonomics, said he recently told clients. And some think "economic cold war is the answer."

Is the Trump administration right?

President Xi Jinping recently told a room full of global investors that China would further open its economy. Officials last week said they would phase out rules that require car manufacturers like General Motors to find a local partner before opening factories in China. They plan to end foreign ownership requirements on electric vehicle makers this year.

This wouldn't mark the first time authorities vowed to shed their protectionist shield. The European Union Chamber of Commerce in China complained last year that foreign businesses were suffering from "promise fatigue."

The problem is China's high-tech ambitions include "plans to use instruments such as subsidized credit and market access restrictions," said David Dollar, a senior fellow at the Brookings Institution and former U.S. Treasury official in China. "It makes sense for the U.S. to oppose this practice."

But Chinese officials see an irony in efforts that try to maintain America's chokehold on innovation. Hua, the Foreign Ministry spokeswoman, likened the U.S. to a "bully — only it can have high tech and others cannot."

Neither side looks willing to bend. Recent talks to de-escalate the trade dispute reportedly collapsed over the 2025 plan.

"China views the overall system as inherently unfair because it was created by the current dominant power," Trivium's Polk said. "America should stop complaining and start designing its own industrial policy to counter China."

Meyers is a special correspondent.

Twitter: @jessicameyers

Kemeng Fan, Gaochao Zhang, and Nicole Liu in The Times' Beijing bureau contributed to this report.

Amid Trump's threats, Xi pledges to slash tariffs, open China's markets

SCMP.COM

China under pressure to live up to open market pledges as US calls for 'reckoning' over 'unfair' trade policies

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Wendy Wu wendy.wu@scmp.com

US raises pressure ahead of World Trade Organisation review by accusing China of causing 'serious harm' by failing to live up to its commitments

China is under pressure to live up to its rhetoric and fully commit itself to opening up its economy in a World Trade Organisation review after the US called for a "reckoning" over what it described as unfair trade policies.

Dennis Shea, the US ambassador to the WTO, accused China of causing "serious harm" by failing to live up to free-trade principles.

The World Trade Organisation is conducting its biennial review of China's compliance.

Macau casinos could get caught in US-China trade war crossfire [1]

"Given China's very large and growing role in international trade, and the serious harm that China's state-led, mercantilist approach to trade and investment causes to China's trading partners, this reckoning can no longer be put off," he said.

"It is clear, moreover, that the WTO currently does not offer all of the tools necessary to remedy this situation," Shea told the two-yearly WTO review of China's trade policies on Wednesday.

But China's vice-minister of commerce Wang Shouwen said significant changes have taken place since China's accession to the WTO in 2001, adding that the country provided market opportunities for world goods and services.

"Between 2001, when China joined the WTO, and 2017, China's imports of goods increased at an annual average rate of 13.5 per cent, twice as high as the world average," he said.

The biennial review is the seventh since China's accession to the WTO.

The country is still subject to frequent criticism for allegedly unfair trade practices, such as restrictions on government procurement to state subsidies for companies.

China's Ministry of Commerce said last week that China had received 1,600-plus questions to be answered in the review from 33 WTO members, covering tariff cuts, market access expansion, state firm reform, subsidies, overcapacity and intellectual property protection.

American families set to pay as US targets Chinese consumer goods [2]

Observers have said that it could help cease tensions with the US and European Union by speeding up talks to allow foreign firms to offer services to local authorities, improve the transparency of its industrial subsidies policy and improve intellectual property protection.

Beijing is aware of the need to ensure a level playing field for all companies, but officials are divided on how to carry out the reforms, according to Chinese trade advisers.

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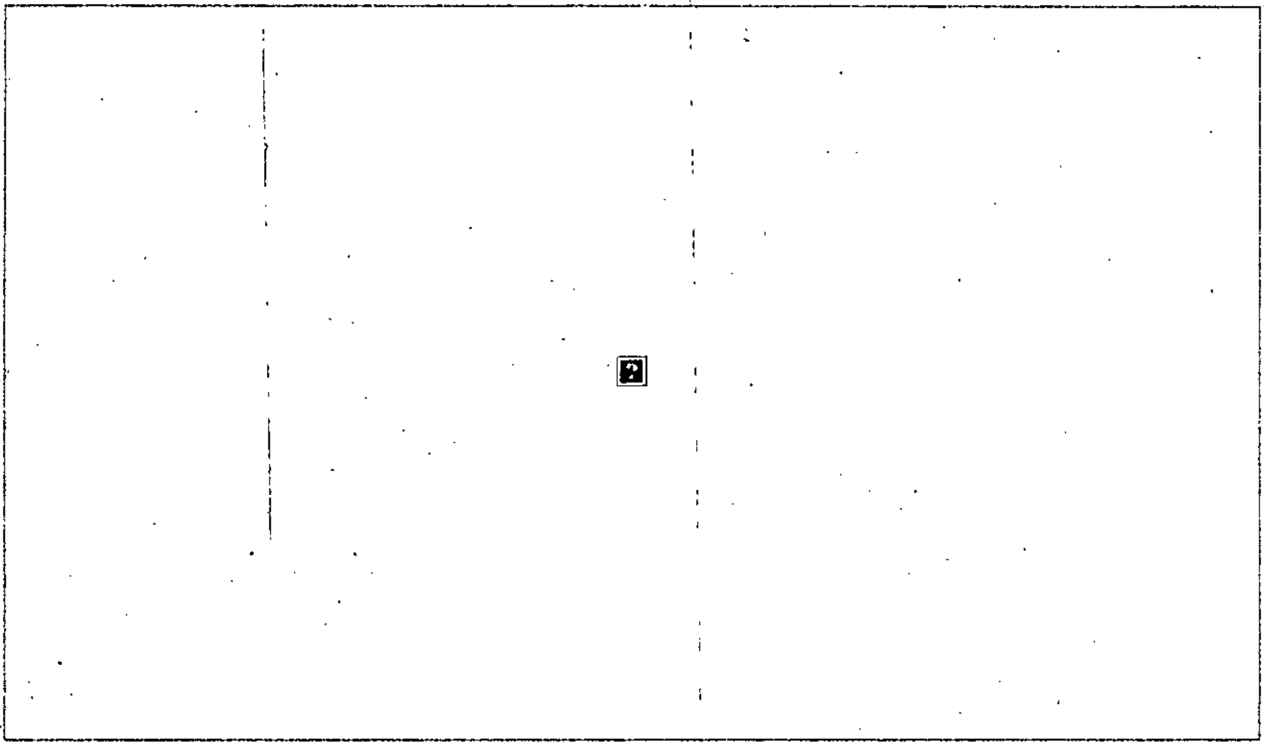
"The glass is half full on China's WTO compliance record, and there is still much work ahead for Beijing to meet its commitments", said James Zimmerman, a partner in the Beijing office of law firm Perkins Coie.



The Chinese government is under pressure to improve its intellectual property protections.
Photo: Weibo

China is a big beneficiary of the current multilateral trade system based around the WTO. In the 17 years since it joined the body in 2001, China has become the world's second largest economy and the top trading partner for over 120 countries.

However, as its economic power rises, foreign governments and businesses have become increasingly frustrated that China is continuing to depict itself as a developing country to justify its use of industrial subsidies, import barriers and market controls to protect domestic industries.

The discontent escalated further when US President Donald Trump lashed out at Beijing's "economic aggression" and unfair trade practices and threatened to withdraw the US from the WTO, which he accuses of favouring China at America's expense.

As trade war hits, China's focus should be on steadying growth [3]

Scott Kennedy, a senior fellow with the Centre of Strategy and International Studies, a think tank based in Washington, said China had to do more to adhere to WTO commitments.

"It [China] currently is falling far short of the mark, and this is one of the reasons for the flagging legitimacy of the WTO in the eyes of the Trump administration and others. China hails the multilateral trading order, but the system is not holding China to account firmly enough," he said.

Trump Clinton B

The EU Chamber of Commerce in China has criticised Beijing for inadequate protections of intellectual property and urged it to fulfil one of its WTO commitments by opening the US$400 billion government procurement market to other members.

Over the past decade, China has submitted six sets of proposals, the latest in 2014, but foreign business groups said they fell short of expectations and urged Beijing to add more local governments and state-owned enterprises to the procurement list to speed up the process.

The Pilot Free Trade Zone in Shanghai. The Chinese government is being urged to do more to open up its economy. Photo: Xinhua

Kennedy said China's performance in terms of WTO commitment compliance and trade cooperation "has plateaued and in some ways regressed", but its efforts to pursue its own interests "have continued apace".

"Although China's contribution to international trade and investment has skyrocketed over the last decade, the simultaneous aggressive expansion of China, Inc. (state champions) and the industrial policy machine has created distortions in its domestic economy and hence distorted the pattern of global trade and investment," Kennedy said.

"If the system continues to treat China with kid gloves, the system essentially will be changed from the inside out into one that no longer takes seriously its mission to reduce beyond-the-border non-tariff barriers".

A large number of the conflicts between China, the US and the EU have centred on fair competition with the role of state-owned enterprises and forced technology transfers among the main sources of contention.

The US has also accused China of failing to completely disclose to the WTO its subsidies to industries, state-owned firms and exporters.

It said in its annual report on China's WTO compliance in 2017 that the body's rules are not sufficient to constrain China's "market-distorting behaviour".

How China plans to push back against Donald Trump in 'economic cold war' [4]

"The notion that our problems with China can be solved by bringing more cases at the WTO alone is naive at best, and at worst it distracts policymakers from facing the gravity of the challenge presented by China's non-market policies," the report said.

Beijing's major Western trade partners have declined to grant China market economy status, which leaves Chinese products at risk of higher punitive tariffs.

A Chinese government adviser, who is familiar with the international trade talks, said China needed to do more to respect WTO principles such as fairness and transparency.

"China has not opened up enough yet and it does not take complaints by foreign companies very seriously, but the US is too impatient," the adviser said.

Beijing has been criticised for stalling on plans to liberalise state firms reinforcing the Communist Party's control over them.

"There is suspicion in China about the West-style market economy after the global financial crisis in 2008. China is more resistant against external pressure while it still lacks a consensus on whether it should rely on state power or the market to make the economy more innovative," the adviser said.

"Inside the government there are still conflicts on how to address state subsidies for industry and a heated debate on how to push forward the reform of state-owned enterprises," said another government trade adviser.

The WTO has gone through several rounds of talks to improve its rules and address issues such as tariffs or its treatment of developing nations.

"There are voices overseas that a 'China Round' of WTO talks is needed. To some extent it makes sense, but China is not ready for that, nor does it have the capacity to lead the making of new rules under WTO", he said.

Topics: US-China trade war
US-China trade war: All stories
China-US relations

More on this: How China plans to push back against Donald Trump in 'economic cold war' [4]

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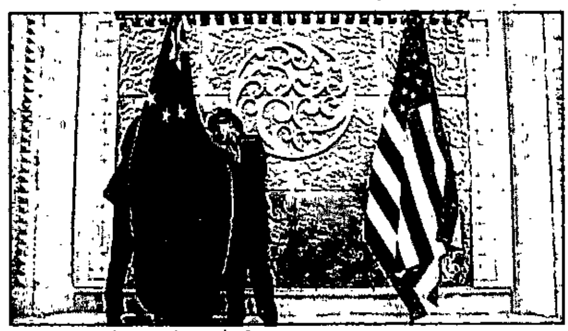
U.S.-China Trade War: How We Got Here

Background reading for the trade war with China.

Blog Post *by* Brad W. Setser

July 9, 2018



Staff members set up Chinese and U.S. flags for a meeting between Chinese Transport Minister Li Xiaopeng and U.S. Secretary of Transportation Elaine Chao at the Ministry of Transport of China in Beijing, China April 27, 2018 REUTERS/Jason Lee

My personal area of expertise is balance of payments analysis—not trade law.

For understanding trade law, I rely on the work of others. A trade war[1] is, among other things, a legal process—at least in the United States. Congress has delegated a lot of authority over the regulation of international commerce to the executive branch, which has given the Trump Administration a lot of latitude. But Trump and his team are still working within the framework of U.S. trade law ("232s", "301s," "201s," etc.).

And they are not working, rather consciously, fully within the framework of the World Trade Organization. The big cases—the 301 versus China, the (coming?) 232 versus autos—are being pursued through U.S. law, and they will be subject to a challenge in the WTO. An alternative

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strategy—challenging China in the WTO for violation of its WTO commitments—hasn't been the administration's focus.

Three Recommended Papers

And I think there are three papers that constitute essential reading for understanding the Administration's choices.

The first is Mark Wu's seminal paper [PDF] outlining why China's party-state fits poorly within the WTO's legal restraints. One reason why China now likes the WTO is that it hasn't significantly constrained China's industrial policy ambitions (while it does bind the United States to its "bound" tariffs, at least in theory). And one reason why the Trump administration hasn't pursued China inside the WTO is that many of the policies that concern the U.S. aren't necessarily WTO violations.

The second is Robert Lighthizer's 2010 testimony [PDF] to the U.S. China Economic and Security Review Commission. It makes for interesting reading today —both for Lighthizer's specific complaints about how China's WTO accession was mishandled (I personally agree with his argument that the U.S. should have made more use of "421" special safeguards in the face of the China shock, and done more to counter China's massive foreign currency intervention) and for the basic strategy he puts forward for responding to what he views as the mistake of letting China into the WTO. He has been thinking about "301s" for a long time—and doesn't believe the U.S. should limit its response to China to actions that stay within the United States' own WTO commitments. The last ten pages of his testimony lay out, I think, the strategy Trump is now pursuing—even if Trump is doing it with a bit of Trumpian flair that goes beyond anything Lighthizer specifically proposed.

The third is Jennifer Hillman's 2018 testimony [PDF] before the U.S. China Economic and Security Review Commission. She fundamentally disagrees with Lighthizer—Hillman, who has previously served on the WTO's top court, believes

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the WTO process around China should be given a chance to work. Hillman recognizes the difficulties of using a set of "narrow" WTO cases to challenge China for specific violation of its WTO commitments. Instead she advocates a global challenge by the U.S. and its traditional allies that would include a case for "nonviolation impairment of benefits"– e.g. challenges to actions that frustrate the intent of the trade liberalization China committed to when it joined the WTO even if the actions aren't technically violations of China's WTO commitments. Such a case would lay the groundwork for the effective renegotiation of China's WTO membership, at least if the threat that the WTO might rule against China in a "big" case was judged credible.

All three articles are informed by a sense of disappointment that China's WTO accession didn't do more to transform the rules of the game inside China's own market. Expectations that China would have to change, politically and economically, to succeed in the global economy haven't been born out—as Ely Ratner and Kurt Campbell argued in Foreign Affairs. China's Communist Party hasn't been tamed by commerce. The Party-State still has firm control over the commanding heights of China's economy—both directly, and indirectly, through its influence on large "private" companies (who can only remain both successful and private with the support of the Party).

Commercial Complaints against China

I also wanted to gather together, for my own use if nothing else, a set of references to the specific policies that China has pursued that have given rise to a set of serious complaints about China's commercial policies. Set aside the "original sin" of ignoring China's massive foreign exchange intervention from 2003 to 2008—and still large intervention in the years immediately after the global crisis. The core of the current complaint is that:

1. China has made it hard to produce abroad and sell to China and,

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2. China has made it hard to invest in China in order to produce and sell in China if your firm isn't Chinese.

The evidence here is in my view somewhat stronger on the first complaint (it is hard to produce abroad to sell to China's domestic market) than on the second complaint (China's home market is reserved for Chinese firms). China's imports of ***manufactures*** as a share of its GDP, net of the electronic components China imports for its electronics export industry, are actually quite small relative to its peers—and they are now lower, as a share of China's GDP, than when China joined the WTO.

And, well, in the sectors where it still imports, China is investing massively to displace those imports—whether of aircraft, semiconductors, or high end medical equipment. That's the core of what China used to call its Made in China 2025 plan. From China's point of view, these are the sectors where China still is overly dependent on imported foreign technology.

And in many cases, the policies that China deploys to support its efforts at import substitution aren't WTO violations per se.

Three broad categories stand out. And in all three cases, the policies "work" in part because of China's massive scale.

1. De Facto Technology Transfer Requirements

The first category is linking inward investment in China to technology transfer to Chinese firms.

Foreign firms often believe that they have to invest in China to supply the Chinese market because of a mix of formal barriers at the border—in many sectors, China's retains fairly high tariffs—and informal pressure to produce in China if you want to sell to China.[2] China often

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tries to impede access to global (e.g. non-Chinese) supply chains if that's needed to help create a Chinese supply chain. Plus, well, producing in China often makes economic sense, as wages in China are still relatively low and China has a diverse manufacturing ecosystem.

China's WTO commitments mean that China cannot legally require technology transfer as a condition for investing in China (see Hillman). Lighthizer's 2010 testimony dug up a quote from President Clinton selling China's WTO accession that hasn't aged well ("We don't have to transfer technology or do joint manufacturing in China anymore").

But China has broad discretion to determine which sectors are open to foreign investment and which sectors are not, and it can condition approval of inward investment on forming a joint venture (JV) partner. Furthermore the JV partner (often a state company, given the nature of China's economy) can condition its participation in the JV on technology transfer (the technology transfer in turn often helps the Chinese firm meet China's goal of raising its level of "indigenous" innovation).

In some sectors, this policy has effectively led foreign firms to transfer technology that led to the creation of an "indigenous" Chinese national champion. **High speed rail** is the most famous example. Firms that wanted to get a contract to provide high speed rail to China's market had to enter into JVs with China's state rail companies, and then into contracts that shifted the location of production of key parts to China. All this was possible because of competition among European, Canadian, and Japanese firms to get access to China's high-speed rail market, as the scale of China's market was simply so big that no firm was willing to ignore it. China's state is effectively the monopoly buyer of railway equipment—so getting access to the market effectively required technology transfer even if China didn't have a written policy requiring it (to my knowledge, China's activities here have not been challenged in the WTO).

In other sectors, the "JV" requirement hasn't led to the creation of an indigenous Chinese competitor.

China has, for example, complained that the JV partners of GM, Ford, Toyota and Volkswagen have gotten lazy and haven't done enough to build up their "indigenous" brands alongside the big international marks. But the combination of the JV requirement and tariffs have led to the development of a deep indigenous supply chain for **autos**—Keith Bradsher has reported that Ford's Chinese supply chain now produces cars of comparable quality to its North American supply chain at a lower cost.[3]

And, well, China clearly intends to use its push into electric vehicles to help develop indigenous Chinese firms—in batteries as well as the production of cars—that will compete with the U.S., German, Japanese, and Korean marks that dominate the global industry right now. And to push Western auto makers to transfer their best technology to China. Bradsher: "Beijing has put very heavy pressure on Western automakers to transfer their latest, most cutting-edge technology to China as a condition of doing business. Many companies, including Volkswagen, General Motors and Ford, have plans to shift more research and development to China, particularly around electric cars." To qualify for China's new electric vehicle subsidies, a firm needs to use a Chinese made battery it seems: "China requires auto makers to use batteries from one of its approved suppliers if they want to be cleared to mass-produce electric cars and plug-in hybrids and to qualify for subsidies. These suppliers are all Chinese."[4]

And in sectors like **semiconductors** where China cannot put up tariff barriers to force production to locate inside China without putting its existing electronics assembly and component manufacturing business at risk, China seems to be resorting to other means to put pressure on firms to help Chinese firms upgrade their technology.

Given China's clear goals, there is always an incentive for foreign firms to form an alliance that puts them on the "right" side of China's policy to become more technologically self-reliant.

cfr *WTO Legal Domestic Subsidies*

The second category is the availability of massive domestic subsidies.

Such subsidies are allowed by the WTO. The WTO prohibits "export" subsidies (though you have to bring the case—no one has challenged the subsidies that Zhengzhou seems to provide Foxconn), but not domestic subsidies.

Fair enough. Shifting too much sovereignty away from the nation-state through binding international commitments has given rise to problems of its own. Dani Rodrik among others has made the case [PDF] that the global rules shouldn't be so binding as to preclude national economic policies/national economic development strategies.

The WTO does allow countries to take action though to offset any "material injury" from imports that are linked to another countries' domestic subsidies and also to seek relief from the "adverse effects" that another countries' domestic subsidies can have in third party markets (though the dispalcement of exports is much harder to challenge in practice, as the "remedy" isn't obvious—retaliation requires identify another sector that you want to tariff, and firms in that sector that rely on imports will complain).

But, as Hillman notes [PDF], challenging China's subsidies in the WTO is often hard (the "WTO's Agreement on Subsidies and Countervailing Measures (ASCM) makes proving the existence of such subsidies difficult"). The WTO is meant to discipline explicit, sector-specific subsidies—the kind that have a budget line item. But in China, the nature of the economy means that in effect any firm that can borrow directly from the state banks rather than the shadow banking system gets low cost credit.

Proving a sector specific subsidy can be difficult.

Is steel more subsidized by the banks than solar? Or in electric vehicles, where China has allowed a thousand flowers to bloom?

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Is every state investment fund—for example the large funds set up to help finance the development of an indigenous semiconductor industry—a subsidy? How do you prove that when state firms dominate the economy?

Here again China's sheer scale matters. China doesn't need to just subsidize a single national champion—it can subsidize credit to multiple competing firms (often in different provinces) and then finance the consolidation of the industry around the most successful firms.

No one else, for example, could set up 30 different provincial semiconductor funds along with several national funds:

"Local governments created at least 30 additional semiconductor funds, with announced financing of more than $100 billion. If all these projects are realized, the global supply of memory chips would outstrip demand by about 25% in 2020, estimates Bernstein Research, pushing prices down and battering profits of semiconductor companies globally."

And well, if some of the funds and investments fail, China is prepared to eat quite large losses along the way. That's what I think happened in the solar sector back in 2010 and 2011. [5]

China's banking system is so big—China's domestic supply of savings is even more inexhaustible than the reservoir of labor in China's countryside—that China can subsidize multiple sectors at once.

Losses in "old" industries like steel and aluminum haven't limited China's ability to provide cheap credit to "new" industries (new electric vehicles, semiconductors, etc). Losses can get moved off to asset management companies and the like and somehow made to disappear over time. (Chapters 2 and 3 of *Red Capitalism*, another crucial reference, describes this process in the mid 2000s)

cfr *"Buy China"*

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The third category is the systemic impact of informal "buy China" policies that direct purchases toward domestic Chinese companies and force firms that want to compete effectively with the local, indigenous champions to make themselves more "indigenous" by producing more in China (ideally with a politically connected JV partner for protection).

In part this is because China hasn't signed on to the government procurement agreement. But the absence of WTO commitment here isn't the only problem.

The real problem is that in the capital intensive sectors where China has the most need for imports, large state firms are often the dominant buyer. In other words, the key preference comes from large state enterprises in their choice of equipment suppliers, not from the "direct" procurement of the central government.

And as Wu notes [PDF], the large role of the "party-state"—with the Party selecting the leadership of key companies—means that informal guidance to "buy Chinese" has real impact (see the market share goals in Made in China 2025).

A few examples.

In **wind power**, big contracts for wind farms come from the State Grid and other big power distributors. That limited the ability of European firms in particular to compete effectively for big contracts even when they set up shop in China—and allowed China to subsidize the creation of Chinese national champions in wind through the backdoor. The Chinese supply chains initially created to help foreign firms meet informal local content requirements helped too.

The government's power grid is also the ultimate source of demand for the firms that produce large turbines for **coal** powered generators, a market China now dominates. And I wouldn't necessarily bet on GE getting a lot of contracts for the generators that will fire China's growing

stock of natural gas fired turbines. GE's joint venture partner certainly looks also to be a potential future competitor as well, though no doubt GE has thought through this risk.

China's goals here aren't a secret, even if China hasn't yet replicated its success in coal-fired turbines.

Rail of course is structurally similar, as the Chinese state through China's various state owned rail companies is the monopoly buyer, but that sector has been discussed earlier—China's various policy tools intersect.

In **medical equipment**, the main buyers are the big hospitals. And the hospitals have been encouraged to favor Chinese production. If for no other reason than to lower costs. The pressure can be subtle as well as overt in a market where foreign suppliers are typically priced at the high-end of the local market:

"According to its 'made in China 2025' initiative, Beijing wants to increase the use of domestically produced devices in hospitals to 50 per cent by 2020, and 70 per cent by 2025, as it seeks to create 'national champions' that can conquer export markets....Several government notices seen by the FT show that the plan is being aggressively implemented. In Sichuan province, officials said in September that ***hospitals must use only China-made devices in 15 categories from respirators to PET-CT scanners***. While protectionist, the moves are permitted under World Trade Organization rules as China is not a signatory to the Agreement on Government Procurement, which covers state-run hospitals. As Chinese devices are generally cheaper, the drive is partly about cost-cutting, with officials using state-insurance funds, which cover an increasing portion of medical costs, as leverage ... 'Imported stents cannot be reimbursed for medical insurance. So we use domestically made ones,' said Li Qiang, a doctor in Sichuan." (emphasis added, from the FT)

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In **telecommunications equipment**, the big buyers are the state-owned telecoms firms. Their orders for indigenous switches and mobile base stations helped build up the "indigenous" Chinese firms—Huawei and ZTE—into major global competitors. And while cellphones are bought by individuals, the choice of phones offered by the big networks matter. Apple likely fears that it could get squeezed out of the Chinese market if the big carriers were pushed to do so…just as China's tech giants are getting pushed to support China's efforts to develop its own chips and cell phone operating systems .

The structural barriers to an indigenous Chinese competitor to Boeing and Airbus in **civil aircraft** (and to GE, Rolls Royce, and Pratt and Whitney in aircraft engines) are large (see James Fallows). Yet the scale of the purchases of China's own state-owned airlines still provides any "indigenous" plane with a captive market. The C919 may only compete with "old" A320s and 737s for now. But China's ability to produce its next generation of aircraft (including a widebody) doesn't really depend on the commercial success of its current generation of planes.

No doubt there are other examples too, even if they aren't as clear cut.

Take **construction equipment**, a sector where not all the buyers are state owned. Chinese heavy equipment manufactures have still come to dominate the local market: "Chinese companies' roots and domestic sales staff give them advantages when dealing with China's diffuse state-owned construction and mining companies, people in the industry say." Caterpillar started setting up joint ventures in China and doing technology transfer a long time ago—but it historically hasn't done all that well in China. To compete, it needed to become more "Chinese." Back in 2014, Caterpillar argued: "that Caterpillar excavators made and sold in China contained more parts produced there than did those of some Chinese rivals … 'We are in some ways more Chinese than the Chinese competitors,' said Mike DeWalt, a Caterpillar vice president." [6]

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Now Caterpillar's Chinese operations want to get in on the Belt and Road action (including getting access to some Chinese tax rebates, which at least to my untrained eye, look a bit like export subsidies).

This all matters, as construction equipment is one of the sector's where the U.S. based producers historically have been very competitive globally—it is a big part of the United States' "indigenous" export base, so to speak.

I personally believe that China's system of domestic preference has a comparable impact on the U.S. economy to the technology transfer policies (and associated IP violations) that tend to get the most attention. China's technology transfer has a mixed impact on the U.S. economy. It keeps U.S. companies from competing for some Chinese business, but it also reduces China's attractiveness as an export base in some sectors (why share profits on sales outside of China with a JV partner). China's domestic preferences encourage firms to produce in China even when it would be more economically efficient (as well as safer, from the point of view of managing the commercial risk) to produce outside China.

Note that I haven't focused on **steel**, or the **internet platforms**. The industries that use steel are in my view more important than the steel producers, and I don't see any realistic way China will agree to hand over the data of China's residents to the U.S. internet giants these days, at least not on terms that the U.S. would like. And I also haven't focused on **agriculture** or **energy**—as these are sectors where China will import (from someone) no matter what. The sectors where technical knowledge is embedded in sophisticated production of specialized components strike me as the most important industrial policy battle ground.

I could go on ...

But, in the interest of being fair and balanced, let me close on a slightly contrary note.

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A country that discourages imports should in the end also export less—it should be less open overall. China 2025 implies that China's economy should eventually come to look more like Brazil—a country with a fairly closed domestic market and limited global export presence.[7]

As a result, the global impact of China's import substituting policies—China's industrial policy largely shifted from export promotion to import substitution after 2009—depends in no small part on China's overall macroeconomic policy settings.

After the crisis, China has, to a degree, offset much of the broader impact of its "buy China" policies through fairly loose macroeconomic policies (lots of off-budget fiscal stimulus, lots of credit) that have directed the bulk of domestic Chinese production toward the Chinese market, rather than the global market.

This redirection of course isn't complete. Even with a fiscal policy that the IMF considers beyond irredeemable, China still runs a current account surplus. And it is all relative—China has grown so fast over the last ten years that even if its exports are down as a share of China's own GDP, they have grown relative to world GDP, and the GDP of China's trading partners.

But it does raise a point that the Trump administration should consider: from a global point of view, China's overall policy settings could be worse than they are now...as the combination of domestic stimulus and the real appreciation of the yuan since 2006 have muted the global impact of China's very real domestic distortions.

Endnotes

1. ^ *The first round of "301" tariffs and China's retaliation technically wouldn't count as a trade war. The $200 billion plus Trump has promised in retaliation for China's tariffs would...*

2. ^ *Airbus has set up an A320 assembly line in China to meet Chinese demand. It recently agreed* to ramp up the pace of production *in China. And, well China is still* pressing for more.

3. ^ *GMs made in China often have more Chinese content than a GM made in the U.S. (which typically has high "NAFTA" content, fair enough in my view—that's what NAFTA was supposed to do.* Source: *"United States government data shows that only 2 percent of the Envision's parts come from the United States."*

4. ^ *I am not a lawyer and this is not legal advice, but I wonder if there is a WTO national treatment violation here—though any firm that brought the case would risk Chinese retaliation against its existing sales.*

5. ^ *"Western solar companies say Chinese banks still lent heavily to the survivors despite low loan-recovery rates from the defaults of big Chinese solar companies like Suntech, Chaori and LDK Solar"* (source).

6. ^ *China's drive to create an* "indigenous" construction equipment manufacturing sector *did open up new opportunities for foreign engine manufacturers like Cummins—though that demand was largely met by Chinese production of Cummins engines, which created a supply chain that* Cummins now uses globally. *This shows up in the trade data: Construction equipment exports to China peaked several years back, while U.S. imports of construction equipment and associated parts from China have increased significantly (see the end-use data).*

7. ^ *I think Keith Bradsher* got this right—*the logical outcome of both Chinese policy choices and Trump's policies should be a China that is less integrated into the global economy. The easiest way to get there? Further appreciation of China's exchange rate.*

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CRS: US-China-U.S. Trade Issues

Wayne M. Morrison, Specialist in Asian Trade and Finance, April 16, 2018 Summary

U.S.-China economic ties have expanded substantially since China began reforming its economy and liberalizing its trade regime in the late 1970s. Total U.S.-China merchandise trade rose from $2 billion in 1979 (when China's economic reforms began) to an estimated $633 billion in 2017. China is currently the United States' largest merchandise trading partner, its third-largest export market, and its biggest source of imports. In 2015, sales by U.S. foreign affiliates in China totaled $482 billion. Many U.S. firms view participation in China's market as critical to their global competitiveness. General Motors (GM), for example, has invested heavily in China, selling more cars there than in the United States annually from 2010 to 2017. In addition, U.S. imports of lower-cost goods from China greatly benefit U.S. consumers. U.S. firms that use China as the final point of assembly for their products, or use Chinese-made inputs for production in the United States, are usually able to lower costs. China is also the largest foreign holder of U.S. Treasury securities (at $1.19 trillion as of October 2017). China's purchases of U.S. debt securities help keep U.S. interest rates low.

Despite growing commercial ties, the bilateral economic relationship has become increasingly complex and often fraught with tension. From the U.S. perspective, many trade tensions stem from China's incomplete transition to a free market economy. While China has significantly liberalized it's economic and trade regimes over the past three decades, it continues to maintain (or has recently imposed) a number of state-directed policies that appear to distort trade and investment flows. Major areas of concern expressed by U.S. policymakers and stakeholders include China's alleged widespread cyber economic espionage against U.S. firms; relatively ineffective record of enforcing intellectual property rights (IPR); discriminatory innovation policies; mixed record on implementing its World Trade Organization (WTO) obligations; extensive use of industrial policies (such as subsidies and trade and investment barriers) to promote and protect industries favored by the government; and interventionist policies to influence the value of its currency. Many U.S. policymakers argue that such policies adversely impact U.S. economic interests and have contributed to U.S. job losses in some sectors.

The Trump Administration has pledged to take a more aggressive stance to reduce U.S. bilateral trade deficits, enforce U.S. trade laws and agreements, and promote "free and fair trade," including in regards to China. In March 2017, President Trump issued an executive order mandating an "Omnibus Report on Significant Trade Deficits" (China accounts for the largest U.S. bilateral trade imbalance, estimated at $371 billion in 2017). In April 2017, he ordered Section 232 investigations into the national security implications of U.S. imports of steel and aluminum (China is the world's largest producer of these commodities). In May 2017, the United States and China announced outcomes of a special "100-day plan on trade," (an initiative that was agreed to by President Trump and Chinese President Xi at their April 2017 meeting), including market access commitments by China on U.S. beef, biotechnology products, credit rating services, electronic payment services, and bond underwriting and settlement. Also in May, the two sides held their first session of the newly-created U.S.-China Comprehensive Dialogue, but with no announced progress on commercial issues. In August 2017, the U.S. Trade Representative (USTR) announced the initiation of a Section 301 investigation of China's IPR policies and technology transfer requirements. In November 2017, President Trump traveled to China, where he announced the signing of $250 billion in commercial deals between U.S. and Chinese firms, and stated that he did not blame China for the large U.S. trade imbalance, but rather, previous U.S. administrations.

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The Heritage Foundation

REPORT Asia

The U.S.–China Economic Relationship: Time for a Change in Tone

August 10, 2017 6 min read

Riley Walters
Research Associate

SUMMARY

U.S. and Chinese officials recently met for the inaugural Comprehensive Economic Dialogue (CED) following a 100-day plan to jumpstart bilateral economic relations. Several notable outcomes, such as a commitment to allow beef exports to China, have been celebrated as successes. Moving forward in U.S.–China economic relations, the Trump Administration and Congress should maintain national security interests, play down future dialogues, take targeted action against intellectual property theft, and protect America's free-market principles.

KEY TAKEAWAYS

U.S. President Trump and Chinese President Xi met in April in Palm Beach, Florida, for a round of U.S.–China economic dialogues including a 100-day plan for reform.

Despite both sides' continued demand for increased cross-border access, for now, further U.S.–China economic coordination may have hit a wall.

The U.S. should highlight the positives in the U.S.–China economic relationship to date—but the U.S. should not expect major changes from China anytime soon.

U.S. economic policies toward China remain a mixed bag of ideas. U.S. and Chinese officials recently met for the inaugural Comprehensive Economic Dialogue (CED) following a 100-day plan to jumpstart bilateral economic relations. Several notable outcomes, such as a commitment to allow beef exports to China, have been celebrated as successes. Despite both sides' continued demand for increased cross-border access, however, for now, further U.S.–China economic coordination may have hit a wall.

Outcomes Since the Presidents' Meeting

U.S. President Donald Trump and Chinese President Xi Jinping met in April in Palm Beach, Florida, and established a new but familiar round of U.S.–China economic dialogues to include a 100-day plan for reform, followed by the inaugural meeting of the CED. The U.S.

and China have held similar formal joint dialogues like this since 2006. An initial report in May from the 100-day sprint signaled several areas of progress.[1]

A joint communique was released announcing:

China will accept imports of U.S. beef, while the U.S. will allow imports of cooked poultry from China;

China's National Biosafety Committee will begin the evaluation of eight U.S. biotech products into China;

China is able to apply for liquefied natural gas exports from the U.S.;

China will allow foreign-owned financial firms to provide credit-rating services;

Both the U.S. and China will work towards a memorandum of understanding regarding information exchange and oversight of cross-border clearing organizations;

China will begin allowing U.S. electronic payment systems to begin the licensing process;

China will issue bond underwriting and settlement licenses for two U.S. financial institutions; and

The U.S. will recognize China's Belt and Road Initiative.

Since the joint communique, both U.S. and Chinese officials have been quiet regarding any further mutual progress in negotiations. Neither the 100-day plan deadline nor the inaugural CED produced any joint public statement regarding ongoing efforts—unlike former dialogues such as the Strategic Economic Dialogue.

There are several reasons for the impasse. For the Chinese side, the approaching 19th Communist Party Congress this fall may limit how much freedom negotiators like Vice Premier Wang Yang may have. Chinese leadership may wish to maintain a certain level of political stability and economic control before possible changes to the Party Politburo. From the U.S. side, a strictly transactional approach to market access can be difficult for negotiators, as the U.S. is already far more accessible an economy. Therefore, Secretary of Commerce Wilbur Ross and Secretary of the Treasury Steven Mnuchin are already limited in what they can take to the negotiating table. Alternatively, threats of restricting Chinese access to U.S. markets can be used as leverage but go against mutual cooperation toward greater economic coordination.

Going Forward

Continued rhetoric from the U.S., such as against Chinese imports, has not helped the U.S.–China relationship, but officials' complaints about Chinese business practices are not ill-founded. Favoritism toward Chinese firms and support of state-owned enterprises have kept U.S. companies from becoming as competitive as they could be in China. Subsidies for state-owned enterprises provide no incentive for U.S. companies to invest in subsidized sectors in China. Theft of intellectual property (IP) for the benefit of Chinese business and state purposes has remained relatively unresolved. And increasing Chinese nationalistic policies are burdening private firms through data localization and other national security requirements. But the Trump Administration has continued to focus on the bilateral trade deficit with China. Chinese negotiators have taken notice of the Administration's infatuation with the trade deficit and have offered to help by asking the U.S. to reduce restrictions on dual-use technologies.

Increased economic relations have mutually benefited the U.S. and China since China began opening its markets to the world in 1978. But in recent years, the pressures of the international market to spur market reforms have stalled. The U.S. and China have potential to continue their mutually beneficial relationship. While the Trump Administration may not like many of the practices that continue in China today, ensuring no harm comes to U.S. consumers in the process is the first priority. And Chinese leadership will need to come to terms with increased foreign competition or else risk not only further loss of growth but continued international displeasure. Japan was able to privatize many of its state-supported industries in the 1980s and maintain a growing economy—but only under leadership that could break through both public and private interests.[2]

Moving forward in U.S.–China economic relations, the Administration and Congress should: Maintain national security interests. Chinese officials have once again offered to correct the trade imbalance by suggesting American restrictions on the export of sensitive, dual-use technology be lifted. Reform of America's export-control regime is long overdue.[3]

There may be things the U.S. can permit to be exported, such as technologies that are now more in common use. But this should be determined through a process that is not designed either to lessen the deficit or otherwise offer country-specific favors. It must result from a balance of commercial and national security interests. There will remain some technologies that are not exportable to China.

Play down future dialogues. Chinese officials may not desire or be able to change domestic policies at this moment. Bilateral relations are based on mutual improvements toward increased competition without government intervention, and China has the furthest to move toward reaching a competitive market. U.S. officials should recognize how little is actually possible until such time as Chinese officials are in a position to return to market liberalization.

Take targeted action against IP theft. Good relations between Chinese and American businesses should be maintained and not caught up in threats of sanctions because of bad actors. Unlike trade measures such as section 232 of the Trade Expansion Act,[4] which could potentially impact all imports of Chinese steel, for measures against stolen IP, the U.S. should limit actions against Chinese imports and investments by targeting specific Chinese companies with U.S. market access known to be using stolen IP. Measures could include a temporary ban of culprits' access to U.S. financial markets.

Protect America's free-market principles. If the Administration truly believes the U.S. is a place for investment and growth, they should act to maintain the U.S. as a destination in which foreign companies want to invest. Increasing scrutiny of investments pushes foreign firms away, limiting future U.S. growth.

Conclusion

Growth and investment returns in the Chinese economy are not as great as they once were. While Chinese negotiators see technologies purchases and investments as keys to growth, growth will continue to stagnate for countries reluctant to pursue structural reforms that emphasize entrepreneurship. Government subsidies for indigenous production of technologies and manufacturing goes against President Xi's promise of letting the market play a decisive role. U.S. and Chinese representatives should continue to highlight the positives in the U.S.–China economic relationship to date—but the U.S. should not expect major changes from China anytime soon.

—Riley Walters is a Research Associate in the Asian Studies Center, of the Kathryn and Shelby Cullom Davis Institute for National Security and Foreign Policy, at The Heritage Foundation.

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China's Intellectual Property Theft Must Stop

By Dennis C. Blair and Keith Alexander

Aug. 15, 2017

President Trump on Monday instructed the office of the United States Trade Representative to consider an investigation into China's sustained and widespread attacks on America's intellectual property. This investigation will provide the evidence for holding China accountable for a decades-long assault on the intellectual property of the United States and its allies.

For too long, the United States has treated China as a developing nation to be coaxed and lectured, while tolerating its bad behavior as merely growing pains. There has been an expectation that as China's economy matures, it will of its own accord adopt international standards in commerce, including protection for intellectual property. There has also been a tendency to excuse mercantilist behavior, including industrial espionage, as a passing phase, and to justify inaction as necessary to secure Chinese cooperation on other, supposedly more important, issues.

Chinese companies, with the encouragement of official Chinese policy and often the active participation of government personnel, have been pillaging the intellectual property of American companies. All together, intellectual-property theft costs America up to $600 billion a year, the greatest transfer of wealth in history. China accounts for most of that loss.

Intellectual-property theft covers a wide spectrum: counterfeiting American fashion designs, pirating movies and video games, patent infringement and stealing proprietary technology and software. This assault saps economic growth, costs Americans jobs, weakens our military capability and undercuts a key American competitive advantage — innovation.

Chinese companies have stolen trade secrets from virtually every sector of the American economy: automobiles, auto tires, aviation, chemicals, consumer electronics, electronic trading, industrial software, biotech and pharmaceuticals. Last year U.S. Steel accused Chinese hackers of stealing trade secrets related to the production of lightweight steel, then turning them over to Chinese steel makers.

Perhaps most concerning, China has targeted the American defense industrial base. Chinese spies have gone after private defense contractors and subcontractors, national laboratories, public research universities, think tanks and the American government itself. Chinese agents have gone after the United States' most significant weapons, such as the F-35 Lightning, the Aegis Combat System and the Patriot missile system; illegally exported unmanned underwater vehicles and thermal-imaging cameras; and stolen documents related to the B-52 bomber, the Delta IV rocket, the F-15 fighter and even the Space Shuttle.

President Trump's action on Monday acknowledges the broad scope of the challenge. Central to Chinese cybersecurity law is the "secure and controllable" standard, which, in the name of protecting software and data, forces companies operating in China to disclose critical intellectual property to the government and requires that they store data locally. Even before this Chinese legislation, some three-quarters of Chinese imported software was pirated. Now, despite the law, American companies may be even more vulnerable.

For decades, successive American administrations have concluded that some level of exposure to China's depredations against our intellectual property is simply the cost of doing business with the world's now second-largest economy. This is not acceptable. Although China is an important trading partner with the United States, it is imperative to establish a fair and level trading environment.

Driving down intellectual-property theft by China and other countries is vital for America's economic well-being and national security. We urge American companies, as well as our allies abroad, who share these interests, to work with the administration through this process.

There is intellectual-property protection on the books in China, and some American companies have been successful bringing cases in Chinese courts. The time may come when China applies the same efforts to protecting intellectual property that it now does to stealing it. However, for now, the United States and other developed countries must look to their own laws and actions to protect their companies from loss and ruin.

President Trump's action on Monday is a major step in the right direction. If the investigation proves extensive Chinese government support for intellectual-property theft, it could trigger retaliatory action by the American government, based on the Economic Espionage Act, Section 5 of the Federal Trade Commission Act and the National Defense Authorization Act.

The government should lead in this effort, but it can't go it alone. A broad, sustained campaign bringing together the government, the private sector and our allies is the only way to halt this hemorrhaging of America's economic life blood.

Dennis C. Blair is a former director of national intelligence and a former commander in chief of the United States Pacific Command. Keith Alexander is a former commander of the United States Cyber Command and a former director of the National Security Agency.

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A version of this article appears in print on Aug. 15, 2017, on Page A23 of the New York edition with the headline: Cracking Down on I.P. Theft

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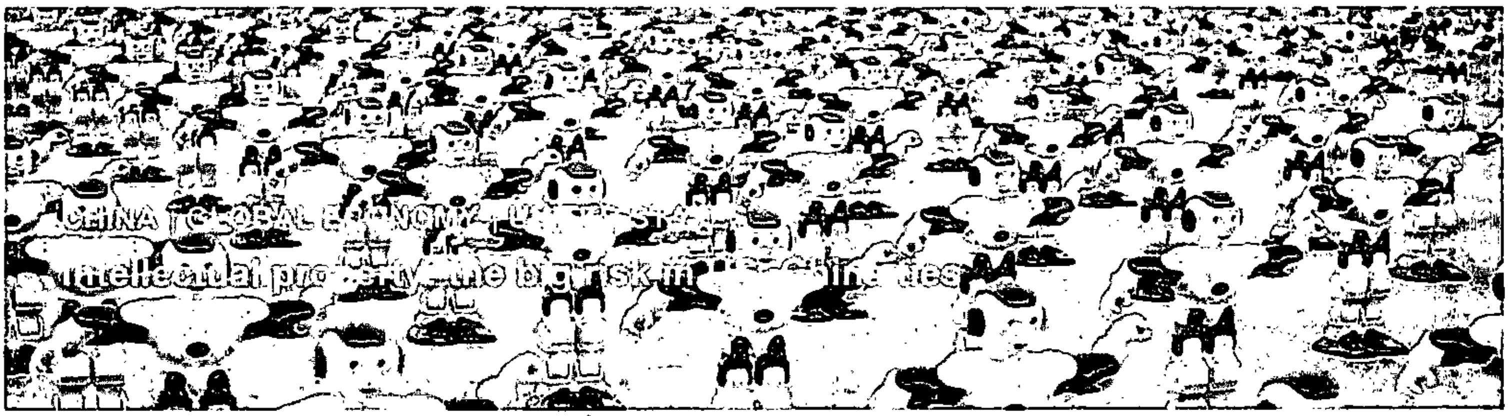

1050 dancing robots at the Qingdao International Beer Festival 2016 (Photo: VCG via Getty)

BY
John Edwards

20 March 2018
13:00 AEDT

It may be chaotic and confused, but the Trump administration is not entirely nuts. Expected to slam China with heavy penalties for appropriating the intellectual property of US businesses, the administration instead appears to be stopping short of a fundamental injury to the world's biggest bilateral trading relationship.

Even so, the developing dispute over intellectual property is now a big risk to US–China economic ties, one that if mishandled has the capacity to hurt the growth of world trade.

According to background briefings given by administration officials to the media last week, President Donald Trump will soon announce a US $30-billion penalty on China's exports to the US in reprisal for what the administration will claim is the cost of Chinese appropriation of US businesses' intellectual property.

In most contexts, $30 billion is a very large amount; however, it is less than 6% of China's annual exports to the US. Depending on the time frame and method of application, the actual cost may be

mitigated. Imposed as, say, a 20% tariff on $30 billion of China's US exports, the cost could come down to something closer to $6 billion, shared between Chinese exporters and US consumers.

The action will be proposed in response to an adverse finding in an investigation under Section 301 of the US Trade Act, initiated in August by the US Special Trade Representative Robert Lighthizer. Much depends on the plausibility of the 301 report, which is delivered as an outcome of the investigation.

The official brief for the USTR investigation was to examine:

> *any of China's laws, policies, practices, or actions that may be unreasonable or discriminatory and that may be harming American intellectual property rights, innovation, or technology development.*

It was, to say the least, a very wide brief. The further the report goes beyond actual offences to World Trade Organization rules, the less support the US will receive from the rest of the world.

The 301 report will likely argue that China has engaged in deliberate, large-scale appropriation of intellectual property from the US. It will allege that Chinese Government authorities, private businesses, and state-owned enterprises have participated in co-option of intellectual property. It will claim that there has been a systematic campaign to target technologies, including robotics, artificial intelligence, and advanced communications. And it will assert that some of these technologies have defence applications, so their importance is not only commercial but also strategic.

The 301 report will probably claim that Chinese corporations and government authorities have used standard commercial means to transfer technology, including commercial licensing agreements, but also less legitimate and less obvious means to which US and other advanced economies should be more alert. These include direct offshore investment in early-stage Western technology businesses; direct offshore investment in mature Western technology businesses; and "involuntary" knowledge transfers required by Chinese authorities as part of the price of access to China's vast and rapidly growing consumption and investment market.

The 301 document may also accuse Chinese authorities of engaging in cybertheft of intellectual secrets and actual commercial

espionage, citing cases that arose during previous administrations.

Most of this is old stuff. With varying levels of annoyance and plausibility, the US has been complaining of theft of intellectual property by China for three decades. It was once an argument over DVDs and fake designer handbags, watches, and jeans. Under successive administrations the argument moved on as China moved up the technology curve.

Nor is the US complaint unique to China. Further back, the US was accustomed to similar disputes with Japan and South Korea. Even today, US officials sometimes portray France as a close second to China in intellectual property wickedness. As recently as May 2014, former US Secretary of Defense Robert Gates said:

> "*[there] are probably a dozen or 15 countries that steal our technology ... in terms of the most capable, next to the Chinese, are the French – and they've been doing it a long time.*"

Rhetorically enlivened by the Trump administration, the US stance on intellectual property will meet very little dissent in Washington. It will be backed by Republicans and Democrats alike, free-traders and protectionists. Once upon a time, US corporations would have lobbied against strong action on China. Perhaps disappointed by their experience in China, perhaps cowed by greater anti-China sentiment as that country has asserted itself in the world, US business is now on the side of sterner action – particularly regarding intellectual property transfers.

China will certainly respond with sanctions on US exports to China, which over the last decade have grown twice as fast as China's exports to the US. But China, like Europe, will be wary of escalating the dispute with the US. It will continue to look to the long game.

Tangled in this coming dispute are much bigger issues for the US, China, and the rest of the world. One is the extent to which the US may wish to obstruct China's declared intention of becoming a leading competitor in high-technology industries. Another is the extent to which the US wishes to frame trade disputes with China as those between a "liberal international order" created and sustained by the US and a state-directed transactional and opportunistic challenge by China.

In its disputes over intellectual property and China's adherence to

WTO undertakings in 2001, the US will be seeking allies. These include Australia, but the major ally the US needs is Europe. The administration appears prepared to refer some aspects of the intellectual property case to the WTO, long portrayed by Trump as the centre of anti-US iniquity in global trade disputes.

To find allies, the administration is evidently now prepared to do what was previously unthinkable. But European support will not be forthcoming unless the US gives ground on its steel and aluminium tariffs due to become effective on Friday.

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Put China's Intellectual Property Theft in a Larger Context

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Commentary

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August 15, 2017

China competes unfairly in international trade, it has long-standing policies to extract intellectual property (IP) from Western companies, and its companies often show scant respect for IP protection. Confronting China over these practices is long overdue, but the central issue is not IP theft but the unfair treatment of U.S. companies in China.

Calculating the value of intellectual property is difficult. One way is to estimate what stolen IP would fetch on the market if offered for sale or licensing. Companies can value their intellectual property by estimating the income it produces or is expected to produce. The most common error is to value IP at what was paid to develop it. The real value (and hence the cost of IP theft) is how much a product made with the IP will fetch on the market. If I spend a billion dollars to develop a square car tire, its market value is zero, not a billion, and the loss from IP theft is zero. Similarly, if I steal IP and can't figure out how to make a product with it, the loss from the theft is zero.

The most accurate measure is to look for competing products. If there aren't any, the harm to the victim is zero. A country could steal "$600 billion" in IP and not gain $600 billion in value. Can we point to products made in China with stolen IP? This explains the difficulty China has faced in its efforts to create a domestic semiconductor industry. Making high-tech products requires "know-how" that can't be obtained by stealing IP. At the high end, there are products in telecom hardware, high-speed trains, and solar power. Copies of designs for consumer goods—furniture, toys, clothing—do real damage to Western companies. However, these losses, while troubling and harmful are not the issue anymore, and IP theft does not explain China's advances in technology.

Stolen IP does not mean that the victim company has lost the ability to make products. What has happened is that it now faces a new competitor. This is the real problem, since China flouts its World Trade Organization commitments and hobbles foreign competition. It has created a protected Chinese market, provides subsidies for foreign sales, and imposes nontariff barriers to hamper Western companies. Subsidized Chinese companies operating from a closed domestic market and selling to an open international market have an immense advantage, and this is a logical strategy.

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China's excuse has been that it is still a poor country, a developing country, and deserves a pass from its trade commitments. Privately, some Chinese say the treatment of foreign firms is owed to them after the "Century of Humiliation," and even more privately, a few consider this a return by China as its rightful place as the "Middle Kingdom" at the center of global affairs. All of this is complete nonsense when coming from the world's second-largest global economy, but there is no reason for China to stop if no one objects.

We do not want to become fixated on IP theft, however. It reflects a mindset from the days when the United States effortlessly led in technology. Those days are gone. If IP theft was so valuable, China would not be trying many other approaches: buying entire Western firms to gain know-how; opening research facilities in Silicon Valley; continuing to demand technology transfer as part of the cost of doing business in China; and spending billions on science education and on research and development. China, after decades of spending, is creating its own culture of innovation, not as effective as America's but better than most countries and lavishly resourced. China will increasingly make its own IP, so stopping IP theft will not keep the United States competitive.

IP theft is part of a larger industrial strategy (described here by my colleague Scott Kennedy). China uses a variety of policies to displace Western companies, including investment, subsidies, barriers to trade, security regulations, procurement mandates, licit and illicit acquisition of foreign technology and Western firms. Western companies find themselves under pressure to make concessions in technology transfer or services like cloud storage in exchange for market access.

China's recent development of a commercial airliner is a good example of the declining importance of IP theft. China's old Soviet-supplied aircraft factories made shoddy aircraft. When China opened its market, Western firms rushed to sell it aircraft, and part of the requirement for market access was coproduction, where Chinese companies worked with Western aircraft firms to make parts for Western commercial aircraft. Coproduction, over 20 years, taught Chinese companies essential production know-how, and the quality of Chinese aircraft has improved markedly. Most of this transfer did not involve IP theft. The problem now is not that China wishes to build commercial airlines, it is that China will be tempted to use subsidies, pressure on domestic airlines to buy Chinese, and barriers to foreign companies to give their manufactures an edge in China and in the global market.

The lessons from the aircraft story are that the United States needs to push back hard on Chinese requirements for transfer technology for market access (something playing out now in the information technology sector) and on Chinese barriers to trade. With skilled diplomacy, we can probably gain support from Germany, Japan, and other major Western economies. They all suffer, but some are reasonably afraid that China will retaliate against their companies. Nor is a trade war a good outcome. If China followed international market practices, a decision to invest in a domestic industry, while having potentially profound effects on the business, would be unobjectionable. Moving China to adopt these practices is not impossible. Steady diplomatic pressure accompanied by skillful use of existing trade authorities (like Section 301 of the U.S. Trade Act of 1974) can change China's behavior.

The word that gives China qualms is "reciprocity." The long-overdue message to China should be that the United States and its partners will hold China accountable for its trade commitments and begin to treat Chinese companies the way China treats Western firms unless there are observable changes. This is half of an effective strategy. The other half is that the United States needs its own strategy to speed and increase its own creation of intellectual property. Complaints alone will not solve this problem.

James Andrew Lewis is a senior vice president at the Center for Strategic and International Studies in Washington, D.C.

Photo Credit: China Photos/Getty Images

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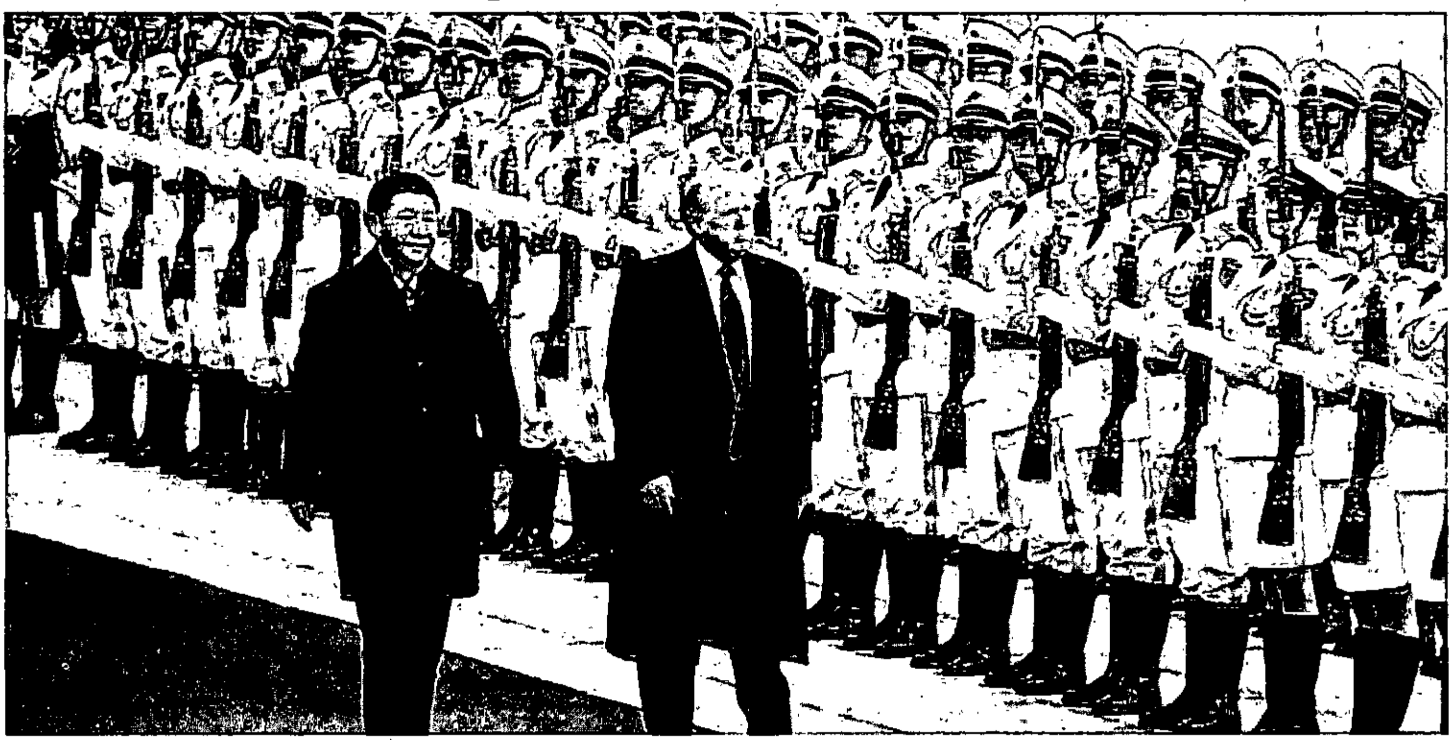
Trump's steel tariffs are nothing compared with the looming war over intellectual property theft with China

Alex Lockie Mar. 8, 2018, 5:37 AM



Donald Trump with Chinese President Xi Jinping. Andrew Harnik/AP

- US President Donald Trump's proposed steel tariffs have caused China to warn of trade wars and potential damage to the US economy, but steel tariffs are nothing compared with the

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coming fight over intellectual property theft.

- Two former senior Defense Department officials said Chinese intellectual property theft cost the US as much as $600 billion a year, calling it possibly the "greatest transfer of wealth in history."

- But with Trump angering the international community in pursuing protectionist practices like tariffs, experts question how he will rally sufficient support against intellectual property theft.

President Donald Trump hinted on Wednesday at what experts predict will become the major economic and diplomatic clash between the US and China — and it will make steel and aluminum tariffs look like small potatoes.

After tweeting that he had asked China to come up with plans to reduce the US trade deficit, Trump brought up the separate but even more important issue of intellectual property theft.

"The U.S. is acting swiftly on Intellectual Property theft. We cannot allow this to happen as it has for many years!" Trump tweeted.

Trump asked China to cut the trade deficit by $1 billion, but two retired senior Department of Defense officials wrote in The New York Times last fall that Chinese intellectual property theft cost the US as much as $600 billion a year, calling it "the greatest transfer of wealth in history."

Steel is small potatoes

A worker operates a furnace at a steel plant in Hefei, China. Thomson Reuters

While China has cautioned against Trump's announced aluminum and steel tariffs, warning they could spark a trade war that would harm the US above all, the tariffs on metals wouldn't

really hurt Chinese businesses, as China exports just 1.1% of its steel to the US.

During a National Committee on US-China Relations call, Jeffrey Bader, a former US ambassador who has spent decades focused on US-China relations, said "China's already under something like 150 anti-dumping and countervailing duty rulings affecting much of the steel industry."

And while the US does make steel, in recent decades the US has created immeasurably more wealth from innovations that hinge on intellectual property being respected.

"This is the PSATs compared to the SATs coming up," Bader said of Trump's push for tariffs, adding that confronting Chinese intellectual property theft was "the big game."

Intellectual property theft is not straightforward to prove, but a recent example includes accusations by the FBI in 2014 that Chinese hackers had stolen sensitive intelligence on 32 military projects, including the new F-35 stealth fighter jet.

But in Bader's view, the US may have already squandered its shot at the "big game."

The 'big game' is coming, but Trump may have already blown it

Carlos Barria/Reuters

"It would be better to try to maintain some semblance of international solidarity with the Japanese and the EU and others," Bader said. Instead, the US appears ready to go ahead with tariffs and protectionist practices that already have key US allies and partners seeking help from the World Trade Organization and threatening trade wars.

Most countries would benefit, on the other hand, from stronger protections against Chinese intellectual property theft. But Trump appears to have divided the world by pursuing the tariffs first.

Privately, US industry figures have long reported Chinese nationals photographing competitive technology. US workers operating in China have been known to abandon their phones and electronic devices and take a walk while discussing important business decisions.

A US Trade Representative report accused China of engaging in "trade secret theft, rampant online piracy and counterfeiting, and high levels of physical pirated and counterfeit exports to markets around the globe."

"Having reversed the sequence" by imposing tariffs first, Bader said, "it's hard to see how there will be much international support" for the US's coming campaign against Chinese intellectual property theft.

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What Stake China Has In American Intellectual Property

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March 23, 2018 · 4:21 PM ET
Heard on All Things Considered

NPR's Audie Cornish speaks with Scott Kennedy, a specialist on China's economy at the Center for Strategic and International Studies about China's stake in American intellectual property.

AUDIE CORNISH, HOST:

Another U.S. sector that relies on the Chinese market is electronics. U.S. companies are pressured to share their industrial secrets if they want to do business in China. The White House says it's a form of intellectual property theft. President Trump argues that tariffs could recoup losses from China's IP theft. Scott Kennedy is a specialist on China's economy at the Center for Strategic and International Studies. Thanks for coming on the program.

SCOTT KENNEDY: Thank you.

CORNISH: The president has used the term theft to describe what's going on. Is it theft? Like, what are we looking at?

KENNEDY: So I think in some areas, we are looking at direct theft. In some areas, we're looking just at coerced pressure where things are, on paper, voluntary. But in reality, you see a lot of handing over of technology because there's really no other choice if you want to enter the Chinese market.

CORNISH: How does that policy work? I'm an American company owner. I say I want to do business in China. Walk me through what the regulations are that would lead me to start to hand over some of my intellectual property.

KENNEDY: If you want to invest in China, produce in China, sell in China, you will need a Chinese partner that will share ownership of your company. You will need to contribute technology, patents, licenses to that joint venture, which you will share. And you will do R&D together in which the Chinese company will gain a stake in.

CORNISH: Can I ask you about one example?

KENNEDY: One example is a Massachusetts company that made semiconductor chips that are really important in wind power. And these chips were developed by them. They owned the IP. But their Chinese partners were able to essentially steal the technology out from under them, open up an alternative production facility and take the market and leave this American company with no market and no technology on its own that it controlled.

And that is not what happens to American companies every day in China. Usually it's less direct, less explicit. But the challenges of operating in China for American companies that have advanced technology are quite mighty.

CORNISH: It sounds crazy frankly 'cause they would never do that here in the U.S. - right? - share with a competitor. Is that market just that good that they need to break into it, will give up anything?

KENNEDY: China is the fastest growing, largest market on the planet ever in history. You take your product. Multiply it by 1.4 billion potential consumers. That's a big opportunity for anybody. General Motors sells more cars in China than anywhere else. Its profits come primarily from China now. Qualcomm - 65 percent of its market for its chips are in China now. So the structural power that China has without even lifting a finger puts companies on the defensive to need to comply.

CORNISH: China at times has said, look; we're going to crack down on theft of U.S. technology. But has there been any movement on that front?

KENNEDY: Over the last 30 years, China has joined every international intellectual property rights agreement. They have laws for copyright, patent, trademarks. They have tried to strengthen implementation of those laws. Yet Chinese high-tech industrial policy is about acquiring technology. So you have a conflict between trying to improve their legal system on the one hand and achieve these very ambitious industrial policy targets on the other.

So the political signals that leading Chinese companies get is that if it's something that the Chinese government really has identified as very important to the national interests, the government may look the other way.

CORNISH: So when you look at the policy that this White House is putting forward, are tariffs the way to go? Is this the way to try and convince China to change its ways?

KENNEDY: I think that unilateral actions including tariffs, the WTO case the U.S. is going to file, the limits on Chinese investment could work, could put enough pressure on China to adapt. But we need to recognize that a trade war needs to be fought smartly, not just tough. And so we are potentially going to lose this trade war, which will leave Chinese industrial policy, including the protection of intellectual property, in a worse situation than we currently find ourselves.

CORNISH: Scott Kennedy is a specialist on China's economy at the Center for Strategic and International Studies. Thank you for coming in to speak with us.

KENNEDY: Happy to do so.

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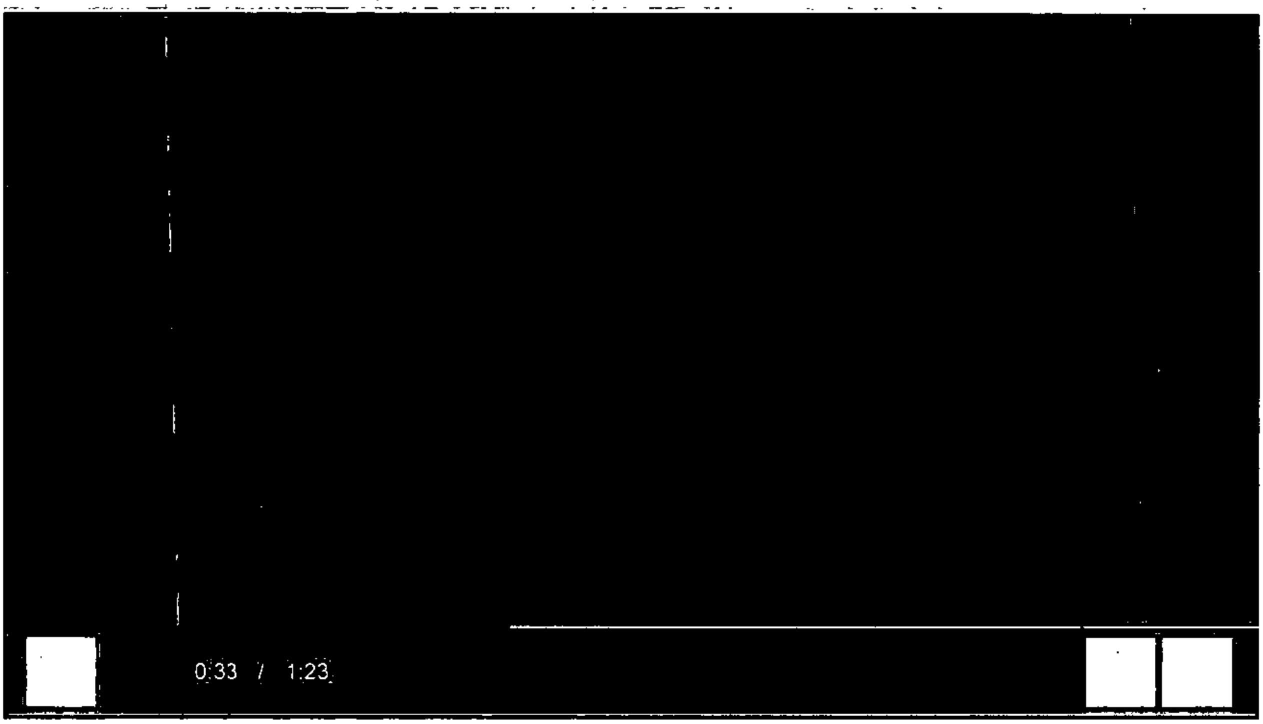
Quicktake

What's Intellectual Property and Does China Steal It?

By Grant Clark and Shelly Hagan
March 22, 2018, 7:58 AM EDT
Updated on March 22, 2018, 3:30 PM EDT



China Could Respond With 'Targeted Retaliation' to Trump Tariffs

As penalties for stealing go, it must rate among the steepest. U.S. President Donald Trump has decided to impose tariffs on $50 billion worth of imports from China as punishment

trade secrets to pressuring companies to share technology with Chinese companies to gain access to China's vast market, have long angered China's overseas competitors. As a result, many companies are wary of doing business there. Efforts to improve enforcement have not come fast enough for Trump.

1. What is intellectual property?

It refers to creations of the mind, such as inventions, literary and artistic works, and designs, symbols, names and images used in commerce, according to the World Intellectual Property Organization. IP is protected in law by patents, copyright and trademarks, enabling people to earn recognition or financial benefit from what they invent or create. "The IP system aims to foster an environment in which creativity and innovation can flourish," the WIPO says.

2. What did Trump do?

In his first trade action aimed directly at China, Trump ordered that tariffs be imposed on a broad range of goods, which could include everything from tennis shoes and baseball hats to lingerie and consumer electronics. The U.S. Trade Representative Robert Lighthizer has 15 days to propose a list of goods that will face higher tariffs. The levies would apply to about 10 percent of the value of China's exports to the U.S., but aren't restricted to products the U.S. says China made in violation of American IP. Trump is also directing officials to pursue a World Trade Organization complaint against China for discriminatory licensing practices and to propose new restrictions on Chinese investments within 60 days to safeguard strategic U.S. technology.

3. What's the rationale for all this?

Lighthizer just completed a seven-month investigation into China and intellectual property at Trump's direction. The $50 billion figure is based on U.S. estimates of the lost corporate earnings caused by China's alleged IP theft or forced technology transfers. U.S. officials were said to find strong evidence that China uses foreign-ownership restrictions to compel American companies to switch technology to local firms and that China supports and conducts cyberattacks on U.S. companies to access trade secrets.

4. How do non-Chinese companies lose money?

Besides missing out on possible sales to counterfeited goods or to Chinese products using their know-how, non-Chinese companies also need to lower their prices to compete in China. They spend billions of dollars to address possible infringements, according to a 2011 report by the U.S. International Trade Commission. That report said trademark infringement was the most common form of IP violation in China, but copyright infringement was the most damaging.

5. What does China say?

President Xi Jinping highlighted the need to speed up protections in a speech last year, calling for stricter enforcement and for infringers to pay a "heavy price." Also in 2017, China started a nationwide campaign to protect foreign firms' international property rights. The Ministry of Commerce says China is a developing country and doesn't have a perfect system to protect IP, acknowledging that there's much work to do . Premier Li Keqiang, in a speech

in March, promised to protect the rights of foreigners investing in its economy.

6. What do others say?

Of 50 countries in the U.S. Chamber of Commerce's International IP Index, which measures a country's commitment to fostering and protecting innovation through legal rights, China ranks 25th. (The U.S. is No. 1 and Venezuela last). China earns praise in that survey for its reforms on patents (the right to make, use or sell an invention) and copyright (the right to express an idea) and its efforts to raise awareness of IP rights. It loses marks for the high levels of infringement and insufficient legal safeguards. William Weightman, a Fulbright Fellow researching IP in China, wrote in The Diplomat that the country has shown a serious resolve to tackle IP-related concerns such as challenges in gathering evidence to document IP infringement, limits on damage awards and bias against foreign firms.

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7. Is this a new gripe by the U.S.?

No, it's a longstanding issue. That 2011 report by the U.S. International Trade Commission estimated that U.S. IP-intensive firms lost $48 billion in 2009 because of Chinese infringements. A 2016 U.S. Trade Representative's report highlighted serious problems, especially concerning the theft of trade secrets. "Offenders in many cases continue to operate with impunity," the report said.

The Reference Shelf

- ▶ A Bloomberg profile of Chinese President Xi Jinping.

Why is the U.S. accusing China of stealing intellectual property?

By Sunny Oh
Published: Apr 6, 2018 1:37 p.m. ET

Beijing's policies long a source of discontent

Win McNamee/Getty Images

U.S. Trade Representative Robert Lighthizer has led the probe into China's intellectual-property policies.

Since China first opened its markets, Beijing has been dogged by accusations that it forces U.S. firms to transfer technology to their Chinese business partners in return for access to the country's 1.4 billion citizens.

Those charges are in the spotlight again after the Trump administration detailed plans to slap tariffs on at least $50 billion of Chinese goods in an effort to punish Beijing for its technology transfer policies, stoking fears of a trade war. After Beijing retaliated with its own set of tariff plans, investors worried that a trade skirmish could turn into a trade war, with the S&P 500 SPX, -0.09% and the Dow Jones Industrial Average DJIA, -0.03% both negative for the year.

Opinion: Chinese stealing is a bigger problem than Chinese steel

As trade concerns looms over Wall Street, here's a guide to why intellectual property features so prominently in trade tensions between U.S. and China.

How large are the economic losses from intellectual property theft?

The Commission on the Theft of American Intellectual Property estimates the annual costs from the loss of intellectual property ranges from $225 billion to $600 billion. Of this amount, it's unclear how much can be attributed to Chinese businesses.

In a 2018 survey conducted by the American Chamber of Commerce in China, more than half of members reported that leakage of intellectual property was a larger concern when doing business in China than elsewhere.

How does China acquire intellectual property?

American firms have to agree to set up a partnership, or joint venture, with a Chinese company to sell their goods in China, with technology transfer thrown into the bargain. Though this type of quid pro quo is formally disallowed by the WTO, analysts say such negotiations are usually conducted in secret.

A paper by the St. Louis Federal Reserve in 2015 estimated that half of the technology possessed by Chinese companies came from foreign firms.

It's not clear, however, if these joint venture arrangements are successful at putting Chinese firms on a level playing field with the rest of the world. Even after the advent of joint ventures, American and German automakers still outsell their Chinese competitors, although analysts say China is catching up.

National security experts say Chinese hackers have also long tried to steal trade secrets from U.S. defense contractors. This prompted former National Security Agency head Keith Alexander to describe Beijing's practices as "the greatest transfer of wealth in history."

But in 2016, FireEye, a U.S. cybersecurity firm, said breaches have seen a marked drop as Chinese hackers turned their attention to more traditional military targets elsewhere in Asia.

Then there's the sale of counterfeit goods in China. Third-party vendors on internet retail platforms owned by the likes of Alibaba have often sold counterfeit goods, according to the U.S. Trade Representative. Alibaba, however, points out it has been more proactive at removing infringing listings, with its founder Jack Ma labeling the problem as a "cancer."

How is the U.S. cracking down on China's practices?

The U.S. has threatened to implement up to $50 billion of tariffs against China through Section 301 of the Trade Act of 1974, meaning the White House does not have to go through the arbitration process ran by the World Trade Organization. This comes after the U.S. Trade Representative's probe into intellectual property theft in August 2017. But invoking Section 301 does mean the U.S. has to file a simultaneous complaint with the WTO.

WTO critics have shown frustration with what they see as an ineffectual and bureaucratic watchdog after China allegedly ran afoul of the organization's intellectual property rules in the past without serious repercussions.

The Committee on Foreign Investment in the United States, an inter-agency committee authorized to review transactions that could result in control of a U.S. business by a foreign entity, has torpedoed several proposed deals that would have seen Chinese firms buy or acquire a controlling stake in U.S. companies on the basis that technology sensitive to national security may be siphoned away.

But this could change, however, as Congress looks into expanding the committee's scope into more routine deals involving the transfer of technologies that don't have implications for national security.

How strong is intellectual property law in China?

China is moving to strengthen intellectual property laws.

China granted a third of all new patents worldwide in 2015, and more and more overseas companies are looking to file patent-related cases in Chinese courts. A recent report by the Santa Clara University School of Law said that foreign firms filed 10% of the patent-related lawsuits in China, winning 70% of those cases and cutting against the widely-held belief that U.S. firms can't get a fair shake in China.

Academics and lawyers say patent infringement is still widespread, but highlight Beijing's resolve to strengthen its intellectual property laws, perhaps in recognition that domestic innovation is being held back by inadequate protections. This broader shift towards stiffer regulation also reflects China's ambition to climb up the value chain as it looks to develop homegrown brands in films, semiconductors and cars, that are often occupied by U.S., Japan and other advanced economies.

One source of complaint for foreign firms is that China also employs a first-to-file patent system, in other words, the first firm to file a trademark will receive it, whether or not they originated the product. This has sometimes allowed Chinese companies to sue American firms like Apple for patent infringement even though the allegedly imitated product was designed by the U.S. company.

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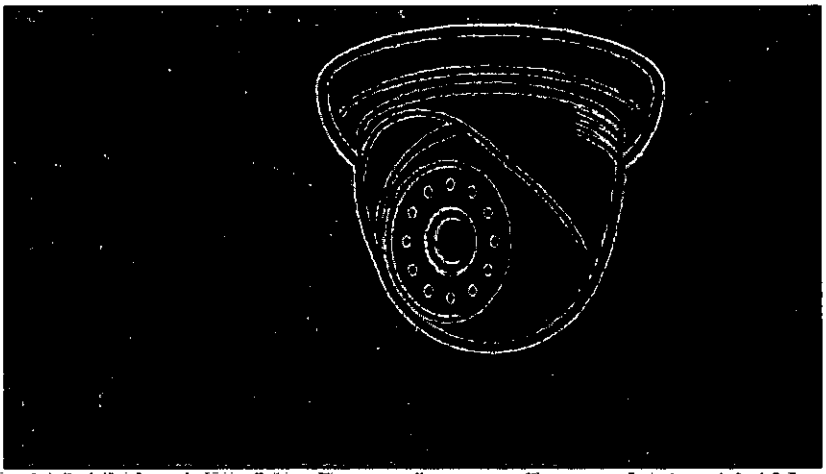
Lawmakers target Chinese sec companies over spy fears

BY KATIE BO WILLIAMS AND MORGAN CHALFANT - 07/10/18 06:00 AM EDT



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Congress is weighing a ban on federal agencies using video surveillance equipment from two large Chinese companies, the latest sign of concerns about foreign espionage among lawmakers.

It's part of a broader trend. Across the government, the U.S. is moving away from foreign state-owned tech companies to prevent cyber spying.

But one of the companies named in the proposed ban is pushing back. Hikvision argues that the legislation — written into the House version of the annual defense authorization bill — is a knee-jerk response to an anti-Chinese "Red Scare."

"To my knowledge, and to my understanding, I've got a gut feeling that if we are not a Chinese company, this wouldn't be an issue at all," said Jeffrey He, president of Hikvision's independent U.S. subsidiary, in an interview with The Hill.

"It's very difficult to prove ourselves not guilty of providing back doors to Chinese government or any source."

Indeed, unlike firms like ZTE or the Russian-owned Kaspersky, it's a much more open question whether Hikvision products are pinging home to China.

Hikvision's U.S.-based business touts its compliance with American laws. It worked with the Department of Homeland Security to patch a security

vulnerability it uncovered in May 2017. It also recently opened a transparency center in California to allow law enforcement to view the source code for its products.

Its cameras have been purchased through middlemen for use on a U.S. military base, the American Embassy in Afghanistan and in a police department in Memphis, Tenn. Chris Nickelson, a Missouri-based contractor, touted Hikvision's products as top-quality cameras with "world-class" support.

Nickelson argues that a ban on Hikvision products would actually harm small American businesses like his.

But Hikvision's parent company's close ties to the Chinese government — a state-run enterprise owns a controlling 42 percent share — and its participation in an extensive state surveillance program in China have raised questions about whether its U.S. arm can be trusted.

Supporters of the amendment to the 2019 National Defense Authorization Act (NDAA) banning government use of Hikvision products note that Chinese laws are written to give Beijing broad authority to intervene in business operations.

"The problem is that in China it's really hard for a company to say no to the government when they come and ask for a request," said James Lewis, a former U.S. official and expert in cyber and national security at the Center for Strategic and International Studies.

According to He, the U.S. company hasn't gotten any requests from Beijing. Moreover, he notes, because the company doesn't sell directly to end users, most of the time Hikvision doesn't even know where its cameras end up.

"To my knowledge in 8 1/2 years in this job, I've not heard anything from anyone, either from the [state-owned enterprise] board members or managing team, that there's any requirement from Chinese government to cooperate," said He. "I have no knowledge, to be honest with you."

The real victims, according to critics of the proposed ban, are the middlemen — often U.S.-owned small businesses. Nickelson, whose company used Hikvision products in a contract installation at Fort Leonard Wood, said the uproar has hurt his business.

Earlier this year, the U.S. Army disclosed that it had removed Hikvision-made cameras from Fort Leonard Wood — but said it did so only to "remove any negative perception" around the base following media reports about the company.

"We never believed [the cameras] were a security risk. They were always on a closed network," said Col. Christopher Beck.

Since The Wall Street Journal named his company in a story about the installation, Nickelson says, he estimates he has lost orders worth "up in the hundreds of thousands."

"I'm damaged," he told The Hill.

Nickelson says if the ban goes through, he will also have to spend thousands on research and development to identify substitute products for government projects already using Hikvision cameras. He says he has already spent between $20,000 and $30,000 "looking at the what-ifs."

"Somebody still needs to show me that there's any real meat and potatoes behind any accusations that have been made towards Hikvision," he said.

Most of the specific warnings about Hikvision revolve around a Homeland Security alert issued in May of last year, which revealed vulnerabilities allowing would-be hackers to remotely exploit some cameras easily..

Hikvision, like other companies dealing with vulnerabilities in their products, issued an update for affected users.

"With regards to this particular flaw, we did work with the research community. We discovered the vulnerability. We worked with the company. And they put out a software update that mitigated the impacts of this particular exploitation," Richard Driggers, a top cybersecurity official at Homeland Security, said in a House Small Business Committee hearing in January. Driggers said the effort followed "standard practice."

Hikvision also patched a second vulnerability, this one affecting its cloud platform, discovered by a security researcher this April.

"The question I'm sure people are asking is, are these accidental or are they purposeful back doors?" Eric Chien, a researcher at software firm Symantec, told The Hill. But Chien said the security vulnerabilities alone could "make users hesitant of using these products," independent of espionage concerns.

The General Services Administration (GSA) removed Hikvision's products from a list of those automatically approved for sale under certain federal contracts last November. While Hikvision never held a GSA contract, its products were sold to the federal government by third-party sellers. A spokesman said the decision was made because the products were not compliant with the Trade Agreements Act, under which China is not a "designated country" where approved products must be manufactured.

The amendment, from Rep. Vicky Hartzler (R-Mo.), whose district is home to Fort Leonard Wood, would go much further. It would prohibit federal agencies buying Hikvision cameras or contracting with "an entity that uses any equipment, system, or service that uses" Hikvision products or services as a "substantial or essential" component of its operations. Federal contractors would have five years to phase out their use of Hikvision-made cameras.

"I am deeply concerned that video surveillance and security equipment sold by Chinese companies exposes the U.S. government to significant vulnerabilities due to potential ... built-in back doors creating a video surveillance network for China, purchased by the taxpayer and installed courtesy of the U.S. government," Hartzler said at a House Armed Services Committee hearing last month.

Nickelson notes that the cameras are often used as part of closed-circuit security systems, meaning that they aren't connected to the internet.

"By the time someone would get to one of our camera systems, the customer has a far bigger problem, because they've already gotten past all of their firewalls," he said.

Officials have stepped up warnings that Beijing is looking to steal sensitive U.S.-made technologies, including through hacking, to gain an edge over the United States.

Beijing appears to be particularly interested in sensitive military technologies. In June, The Washington Post reported that Chinese government hackers accessed a Navy contractor's computer and stole details on a secret submarine missile program.

The escalating worries about China have been highlighted by ZTE, a Chinese phone manufacturer that experts have long considered a potential security threat.

Earlier this year, senior intelligence officials testified that they would not recommend American citizens use products made by ZTE or Huawei, another Chinese telecom company. The Pentagon in May ordered military bases to stop selling ZTE and Huawei devices over security concerns.

The House-passed version of the National Defense Authorization Act would also bar the federal government and federal contract recipients from using ZTE or Huawei devices; Hartzler's amendment would expand the ban to include Hikvision and Dahua Technology, another Chinese video surveillance company, as well as Chinese radio manufacturer Hytera.

National security experts say that lawmakers are simply trying to eliminate the risk that devices could be used for spying, even if there is not yet hard evidence of espionage.

"I think the idea was, let's catch them all and not worry about the fact that this is unfair to a Chinese company," said Lewis. "Is every federal contractor doing sensitive work? No, but it's easier just to say don't use Hikvision."

But it's difficult for Hikvision to prove that it is not acting as a Trojan horse for the Chinese government.

In March, Hikvision opened a transparency center in California so U.S. agencies could review the source code for their products.

So far, Hikvision says, no one has made an appointment.

TAGS VICKY HARTZLER SURVEILLANCE CHINA SECURITY CAMERAS

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POLITICO INVESTIGATION

How China acquires 'the crown jewels' of U.S. technology

The U.S. fails to adequately police foreign deals for next-generation software that powers the military and American economic strength.

By **CORY BENNETT** and **BRYAN BENDER** | 05/22/2018 05:10 AM EDT

POLITICO Illustration/Getty Images/iStock

The U.S. government was well aware of China's aggressive strategy of leveraging private investors to buy up the latest American technology when, early last year, a company called Avatar Integrated Systems showed up at a bankruptcy court in Delaware hoping to buy the California chip-designer ATop Tech.

ATop's product was potentially groundbreaking — an automated designer capable of making microchips that could power anything from smartphones to high-tech weapons systems. It's the type of product that a U.S. government report had recently cited as "critical to defense systems and U.S. military strength." And the source of the money behind the buyer, Avatar, was an eye-opener: Its board chairman and sole officer was a Chinese steel magnate whose Hong Kong-based company was a major shareholder.

Despite those factors, the transaction went through without an assessment by the U.S. government committee that is charged with reviewing acquisitions of sensitive technology by foreign interests.

In fact, a six-month POLITICO investigation found that the Committee on Foreign Investment in the United States, the main vehicle for protecting American technology from foreign governments, rarely polices the various new avenues Chinese nationals use to secure access to American technology, such as bankruptcy courts or the foreign venture capital firms that bankroll U.S. tech startups.

The committee, known by its acronym CFIUS, isn't required to review any deals, relying instead on outsiders or other government agencies to raise questions about the appropriateness of a proposed merger, acquisition or investment. And even if it had a more formal mandate, the committee lacks the resources to deal with increasingly complex cases, which revolve around lines of code and reams of personal data more than physical infrastructure.

POLITICO MONEY

By BEN WHITE

"I knew what was critical in 1958 – tanks, airplanes, avionics. Now, truthfully, everything is information. The world is about information, not about things," said Paul Rosenzweig, who worked with CFIUS while at the Department of Homeland Security during President George W. Bush's second term. "And that means everything is critical infrastructure. That, in some sense, means CFIUS really should be managing all global trade."

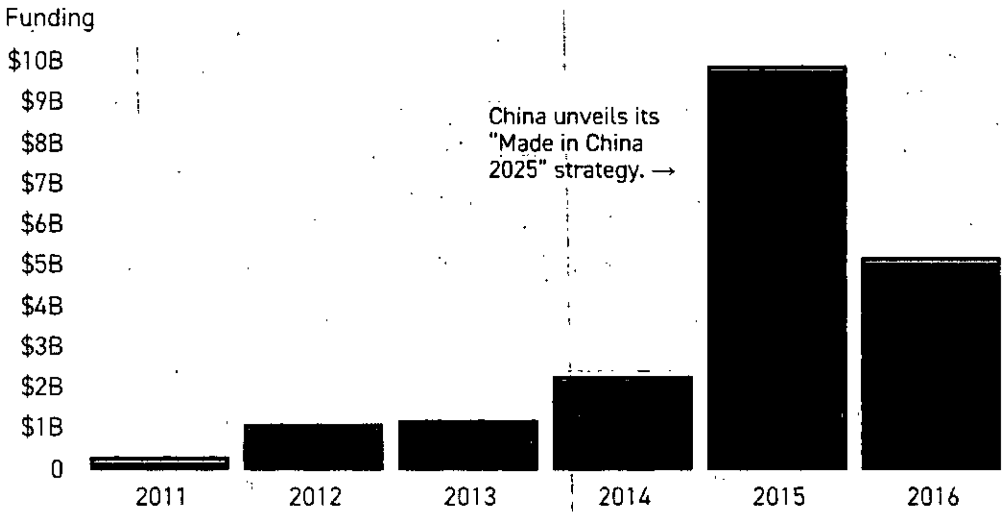
As a senior official at the Treasury Department, which oversees CFIUS, put it: "Any time we see a company that has lots of data on Americans – health care, personal financial data – that's a vulnerability."

When CFIUS was formed, in the 1970s, the companies safeguarding important technology were so large that any takeover attempt by foreigners would be certain to attract attention. Now, much of the cutting-edge technology in the United States is in the hands of much smaller firms, including Silicon Valley startups that are hungry for cash from investors.

The gap in oversight became a more urgent problem in 2015, when China unveiled its "Made in China 2025" strategy of working with private investors to buy overseas tech firms. A year earlier, Chinese investments in U.S. tech startups had totaled $2.3 billion, according to the economic research firm CB Insights. Such investments immediately skyrocketed to $9.9 billion in 2015. These amounts dipped the following year, as the Obama administration voided a high-profile deal, but analysts say China's appetite to buy U.S. firms and technology is still strong. In 2017, there were 165 Chinese-backed deals closed with American startups, only 12 percent less than the 2015 peak.

Money invested in U.S. tech from China region

Investments from the Greater China Region (China, Hong Kong, Taiwan) to U.S. tech companies skyrocketed from $2.3 billion in 2014 to $9.9 billion in 2015, though they fell in 2016.



SOURCE: CB Insights

Chinese investment in U.S. tech startups

Chinese investor-backed deals with U.S. tech startups jumped 185 percent from 2013 to 2015, though the cash influx has recently tapered off: In 2017, deals fell 12 percent from their 2015 peak.

SOURCE: CB Insights

Yet the failure to investigate some forms of Chinese investments in American technology has flown under the radar as President Donald Trump goes tit for tat with Beijing, imposing tariffs meant to punish China for unfair trade practices. Critics noted on Monday that Trump's tentative agreement to drop his tariff threat in exchange for Chinese pledges to purchase billions of dollars more in American goods avoided any mention of the outdated foreign-investment policies that have alarmed lawmakers across the political spectrum.

On the Senate floor Monday, Minority Leader Chuck Schumer (D-N.Y.) lashed out at Trump's approach.

"China's trade negotiators must be laughing themselves all the way back to Beijing," he said. "They're playing us for fools — temporary purchase of some goods, while China continues to steal our family jewels, the things that have made America great: the intellectual property, the know-how in the highest end industries. It makes no sense."

National security specialists insist that such a stealth transfer of technology through China's investment practices in the United States is a far more serious problem than the

tariff dispute — and a problem hiding in plain sight. A recent Pentagon report bluntly declared: "The U.S. does not have a comprehensive policy or the tools to address this massive technology transfer to China." It went on to warn that Beijing's acquisition of top-notch American technology is enabling a "strategic competitor to access the crown jewels of U.S. innovation."

Some congressional leaders concur. Senate Majority Whip John Cornyn (R-Texas) regularly warns his colleagues that China is using private-sector investments to pilfer American technology. China has "weaponized" its investments in America "in order to vacuum up U.S. industrial capabilities from American companies," Cornyn said at a January hearing. The goal, he added, is "to turn our own technology and know-how against us in an effort to erase our national security advantage."

Legislation to expand the CFIUS budget and staff has been moving slowly through the halls of Congress amid pushback from Silicon Valley entrepreneurs and business groups. The legislation would give CFIUS new resources to scrutinize bankruptcy purchases and establish stricter scrutiny of start-up investments.

As months passed without any action, and the issue of Chinese investments got overshadowed by tariff fights and feuds between Beijing and the Trump administration, national security experts grew more concerned, fearing that Congress lacked a sense of urgency to police transfers of sensitive technology.

The White House began exploring what more it could do on its own, asking the Treasury Department in late March to offer a list of potential Chinese investment restrictions within 60 days.

Finally, earlier this month, Senate and House leaders announced plans to mark up the bill, starting a process that could lead to passage later this year.

Still, the failure to act more quickly may itself be jeopardizing national security. At a hearing in January, Heath Tarbert, the Treasury Department assistant secretary overseeing CFIUS, testified that allowing foreign countries to invest in U.S. technology without making sufficient background checks "will have a real cost in American lives in any conflict."

"That is simply unacceptable," he said.

'Made in China 2025'

Last October, Chinese President Xi Jinping took the podium before 2,300 Communist Party delegates to deliver his expansive vision for China's future.

Xi was speaking at the party's 19th Congress, a summit held every five years to choose the nation's leaders in the Great Hall of the People in Beijing, the expansive theater right off Tiananmen Square. Speaking in front of a giant gold hammer and sickle framed by bright red drapes, Xi held forth for 3½ hours, declaring that China would look outward to solve its problems.

"China will not close its door to the world — we will only become more and more open," Xi declared to his rapt audience of party leaders, many of them having close ties to the billionaire investors who represent China in the global market. "We will deepen reform of the investment and financing systems, and enable investment to play a crucial role in improving the supply structure."

China watchers said Xi was alluding to the government's relatively new economic plan, dubbed "Made in China 2025," which leaders had unveiled in 2015. The detailed vision shifted the focus on domestic research investments to the need to pump money into — and better understand — foreign markets.

"We will," the document proclaimed, "guide enterprises to integrate into local culture."

"We will," the document continued, "support enterprises to perform mergers, equity investment and venture capital investment overseas."

At the top of the investment wish list were high-tech industries like artificial intelligence, robotics and space travel.

For the increasingly powerful Chinese leader, it was the culmination of years of efforts to guide how China spends its blossoming wealth. In addition to luring foreign companies to China, Xi wanted the country — which is sitting on several trillion dollars in foreign exchange reserves — to start investing abroad.

The plan had "much more money behind it" and "much more coordination" between Beijing and Chinese industrialists than previous economic strategies, according to Scott Kennedy, an expert on Chinese economic policy at the Center for Strategic and International Studies, a Washington think tank that specializes in defense matters.

"And a big component of that is acquiring technology abroad," he said.

From 2015 to 2017, Chinese venture capitalists pumped money into hot companies like Uber and Airbnb, but also dozens of burgeoning firms with little or no name recognition. The country didn't just want "trophy assets," Kennedy explained. China's leaders wanted to "fill in some of the gaps they have" in China's tech economy.

While the Asian power has piled up profits from its large manufacturing plants that churn out low-cost products, the Beijing government realized it would face declining productivity unless its economy, from agriculture to manufacturing, adopted high-tech methods. Essentially, China wanted to automate entire industries — including car manufacturing, food production and electronics — and bring the whole process in-house.

So Beijing's leaders encouraged the country's cash-rich investors to search for "emerging companies that have technologies that may be extremely important ... but aren't proven," Kennedy said. The initiative has spawned investments in American startups that work on robotics, energy equipment and next-generation IT. Of particular concern to U.S. national security officials is the semiconductor industry, which makes the microchips that provide the "guts" of many advance technologies that China is seeking to leverage.

"A concerted push by China to reshape the market in its favor, using industrial policies backed by over one hundred billion dollars in government-directed funds, threatens the competitiveness of U.S. industry and the national and global benefits it brings," declared a January 2017 report from the President's Council of Advisors on Science and Technology, warning of the urgent threat to U.S. superiority in semiconductor technology.

Notably, many of China's investments didn't register on the CFIUS radar. They involved the early-seed funding of tech firms in Silicon Valley and low-profile purchases such as the one in Delaware bankruptcy court. They included joint ventures with microchip manufacturers, and the research and development centers created with international partners.

"They have diversified to look for smaller targets," Kennedy said. "Those things typically do not generate a CFIUS reaction. That is part of it."

An obscure research body

CFIUS was set up by Congress in 1975 amid growing concerns about oil-rich countries in the Middle East buying up American companies, from energy firms to armsmakers. Chaired by the Treasury Department, the committee brought together representatives from all the major Cabinet agencies to assess the financial, technological and national security

threats posed by such investments. For its first decade, however, CFIUS existed mostly as an obscure research body. From 1975 to 1980, the committee met only 10 times, according to congressional reports.

Japan's economic ascendance in the 1980s changed that. The Defense Department asked CFIUS to step in and investigate potential Japanese purchases of a U.S. steel producer and a company that made ball bearings for the military. In 1988, Congress gave the committee the authority to recommend that the president nix a deal altogether. Still, the committee remained mostly an ad hoc operation into the 1990s.

"Bureaucratically it was not a very smooth, functioning operation," recalled Steve Grundman, who worked as part of the committee during the Clinton administration. "We had to pick up some intelligence here, some technology assessment there, some industrial analysis hither."

After the Sept. 11, 2001, terrorist attacks, Congress renewed its interest in CFIUS, passing legislation that instructed the committee to consider a deal's effect on "homeland security" and "critical industries," a notable change, according to Rosenzweig, the DHS official who worked with CFIUS during the George W. Bush administration. The directive gave the committee a mandate to keep an eye on a wider array of industries, such as hospitals and banks, that DHS considered "critical" to keeping American society operating.

Rosenzweig called it a "singular shift." Over time, he said, the committee went from reviewing acquisitions of steel companies — involving just two parties and a tangible product — to investigating technically complex purchases of microchip companies and other software or data-rich firms.

"When I first came to CFIUS, the filings from the other side would be a few-page letter about why this was a good deal," Rosenzweig said. "Now it's a stack of books that's up to my knee."

The committee's staffing and resources have not kept pace with the growing workload, multiple people who work with CFIUS told POLITICO. While the Treasury Department has been hiring staffers and contractors to help handle the record workload, the committee's overall resources are subject to the whims of the individual agencies involved in the process, said Stephen Heifetz, who oversaw the CFIUS work at DHS during the second Bush administration.

There is no single budget or staffing figure for CFIUS. Instead, each agency decides the level of personnel and funding it's willing to commit to the committee. The Treasury

Department and DHS have two of the larger CFIUS teams, Heifetz said. During his tenure, Heifetz's DHS squad included roughly 10 people, split equally between government workers and outside contractors.

"Each agency decides more or less on their own how they're going to staff it," Heifetz said.

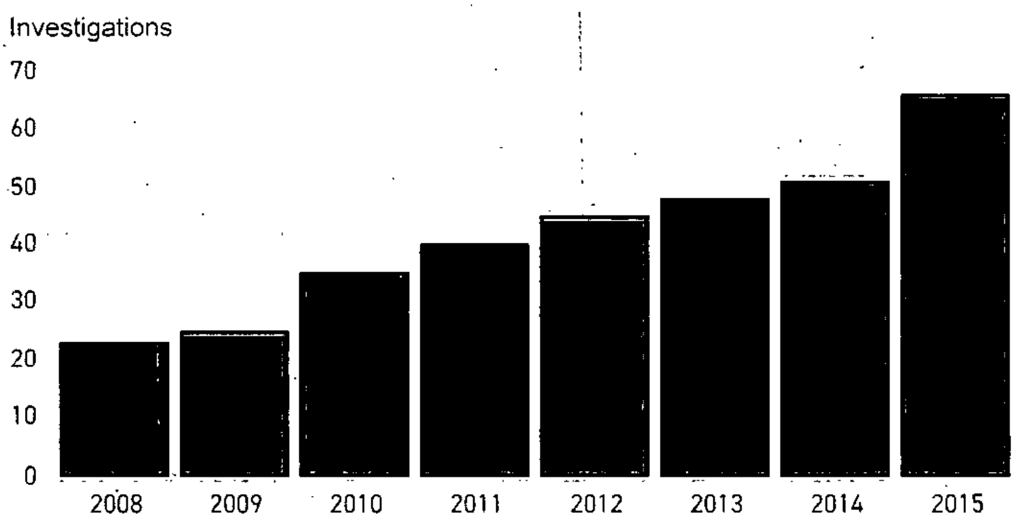
At Treasury, there are now between 20 and 30 people working for CFIUS, according to a senior department official. But even with the expanded team, the committee is stretched precariously thin. The official described 80-hour workweeks, regular weekend work and no ability to take time off.

"It's enough to handle the current mandate, but not comfortably," the official said.

Amid this uncertainty over resources, CFIUS investigations into foreign acquisitions nearly tripled from 2009 to 2015. The most common foreign investor that hits the CFIUS radar is now China. Nearly 20 percent of the committee's reviews from 2013 to 2015, the most recent data available, involved the Asian power, easily ahead of second-place Canada at just under 13 percent.

Foreign investment investigations

From 2008 to 2015, CFIUS investigations into foreign acquisitions nearly tripled.



SOURCE: Annual Report to Congress, CFIUS

Countries under review

The most common foreign investor on the radar of the Committee on Foreign Investment in the United States is China. Nearly 20 percent of the committee's reviews from 2013 to 2015 involved China.

Total	387
China	74
Canada	49
U.K.	47
Japan	41
France	21
Germany	14
Netherlands	14
Switzerland	12
Singapore	12
Hong Kong	9
Israel	9
Australia	8
South Korea	8

SOURCE: Annual Report to Congress, CFIUS

Since 2015, the Treasury official said, those trends have only continued: Chinese deals now represent a large plurality of the committee's work.

The attention appears to be well-founded. In recent years, China has been repeatedly accused of industrial espionage — using indirect means to obtain American software and military secrets, everything from the code that powers wind turbines to the designs that produce the Pentagon's modern F-35 fighter jets. And several Chinese businessmen have pleaded guilty to participating in complex conspiracies to get their hands on sensitive technical data from U.S. firms and shuttle it back to Beijing. Again and again, high-tech products and military equipment have popped up in China that bear a too-striking resemblance to their American counterparts.

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Spurred by these incidents, CFIUS has successfully advised the president to nix Chinese deals at a record clip. In December 2016, President Barack Obama stopped a Chinese investment fund from acquiring the U.S. subsidiary of a German semiconductor manufacturer — only the third time a president had taken such a step at that point. In September 2017, Trump halted a China-backed investor from buying the American semiconductor maker Lattice, citing national security concerns.

Three months later, a Chinese company's plan to acquire the American money transfer company MoneyGram fell apart when the two sides realized they would likely not get CFIUS approval because of concerns that the personal data of millions of Americans — including military personnel — could fall into the hands of the Chinese military.

Weeks after that, the committee essentially jettisoned a Chinese state-backed group's attempt to buy Xcerra, a Massachusetts-based tech company that makes equipment to test computer chips and circuit boards. Then, in March, Trump blocked the purchase of the chipmaker Qualcomm by Singapore-based Broadcom Ltd. CFIUS said such a move could weaken Qualcomm, and thereby the United States, as it vies with foreign rivals such as China's Huawei Technologies to develop the next generation of wireless technology known as 5G.

To national security leaders, though, CFIUS is still only scratching the surface of China's ambitions to acquire U.S. technology, noting that traditional sale-and-purchase agreements to obtain a U.S. company aren't the only ways to gain access to cutting-edge technology.

"You can buy a [partial] interest in a company and gain access to the same type of technology," Attorney General Jeff Sessions told Congress in October, adding that Justice Department investigators "are really worried about our loss of technology" in instances where Chinese investors buy small stakes in American tech companies.

The U.S. military has raised similar concerns. Defense Secretary Jim Mattis warned last summer that America is failing to restrict foreign investments in certain types of critical industries, testifying during another hearing that CFIUS is "outdated" and "needs to be updated to deal with today's situation."

A mysterious takeover

The case that occurred last summer in an obscure courtroom in Delaware seemed innocuous enough: one relatively small tech firm buying out a bankrupt competitor, a transaction that elicited about as much drama as mailing a letter.

The bankrupt semiconductor maker ATop Tech had only 86 employees when it was declared insolvent. But it had a more than a $1 billion market share of the electronic-design automation and integrated circuits markets, the company told the bankruptcy court, giving it potential value to any player seeking to enter the highly specialized semiconductor industry.

Avatar Integrated Systems, the company seeking to purchase ATop, was apparently such a player. But it was not well known to others in the semiconductor industry, and its precise ownership was a bit of a mystery. The sole director listed on its incorporation papers was a Hong Kong-based businessman named Jingyuan Han, and it issued shares to King Mark International Limited, a Hong Kong company in which Han was an investor. Avatar was set up in March 2017, according to the company.

The transaction went ahead despite concerns raised to the court by other players in the semiconductor industry, as well as those of a former senior Pentagon official who specifically suggested the Chinese government may be backing Avatar.

The former Pentagon official, Joseph Benkert, was enlisted by another American semiconductor company, Synopsys, to help recoup money it was owed by ATop. He warned the court that the deal might have national security risks.

"CFIUS has identified businesses engaged in design and production of semiconductors as presenting possible national security vulnerabilities because they may be useful in defending, or seeking to impair, U.S. national security, as semiconductor design or production may have both commercial or military applications," Benkert, the former assistant secretary of defense for global affairs under the second Bush administration, wrote to the court.

Benkert argued that the question of Avatar's ownership needed more review given that the company appeared to be "under the control of Han, a Chinese national."

"In my opinion," Benkert wrote, "the proposed transaction is likely to receive thorough CFIUS scrutiny and there is a material risk that it will not receive CFIUS approval."

But despite those concerns, the deal to buy ATop Tech was not given a formal review by CFIUS, according to a senior administration official with direct knowledge of the process. A Treasury Department official, speaking on behalf of CFIUS, declined to comment on the merger.

An Avatar official, reached at the company office in Santa Clara, California, did not respond to questions or a request for an interview with Han. The company did not respond to multiple requests to discuss its relationship — if any — with the Chinese government or the details of its business.

Han, who has been described in media reports as one of China's wealthiest men, has spent his career almost entirely in the iron and steel industries. Avatar's scant history seemed to suggest that it was created for the sole purpose of acquiring an established American semiconductor firm like ATop Tech, according to several former national security officials who still work on CFIUS cases.

Attempts to reach Han through China Oriental Group, the iron and steel company that he runs, were also unsuccessful.

Officials familiar with the CFIUS process say that bankruptcy deals such as the Atop-Avatar case sometimes fall off their radar because of difficulty in discerning whether Chinese investors are working with the government. In other bankruptcy cases, Chinese investment in a potential buyer may not be visible in official filings, especially when a web of holding companies is involved. Thus, say current and former officials working with CFIUS, a significant amount of detective work is necessary to discern both the identity and the intentions of the investors.

Traditionally, courts have defined control of a company as "the ability to direct management to make certain decisions." But a former Treasury Department official said CFIUS needs to focus on "beneficial ownership," defined as having the ability to obtain technology from the firm, rather than overall decision-making power.

"It is very hard to find beneficial ownership," said the official. "Our concern is the capacity of the system to deal with these."

The bills pending in Congress to strengthen the CFIUS review process include provisions designed to make scrutiny of bankruptcy cases easier. The bills would require CFIUS to "prescribe regulations to clarify that the term 'covered transaction' includes any transaction ... that arises pursuant to a bankruptcy proceeding or other form of default on debt."

A sharper focus on bankruptcy cases, particularly in making sure CFIUS scrutinizes investors to ties to foreign governments, is desperately needed, said a former Pentagon official who is still involved in CFIUS cases. "How do they find out about it now? They are reading The Wall Street Journal late at night," the official said. "It is not a very systematic process."

The former official also recalled that in the past, the Pentagon has hired an outside contractor to scour around for unreported transactions that might raise some national security flags, such as in the semiconductor or aerospace sectors. Such checks need to be performed in a more systematic way.

"There is no process for surfacing information out of the bankruptcy courts," the official said.

China goes to Silicon Valley

In Silicon Valley, Chinese investment isn't typically viewed as a threat, but rather more of a blessing.

Chris Nicholson, co-founder of Skymind, an artificial intelligence company that makes the type of cutting-edge software that both the United States and China covet, recalls the many long months he spent in 2014 trudging up and down Sand Hill Road, the heart of Silicon Valley's leading venture capital firms, and all the doors that slammed shut.

"That was a long, dry year for us," he told POLITICO.

Nicholson hadn't sought Chinese money. But then Tencent, China's internet and telecommunications giant and now one of the world's largest companies, approached the firm, offering $200,000 in seed funding. The Chinese monetary infusion buoyed Skymind, which soon landed a coveted spot in Y Combinator, the powerful startup accelerator. American investors, who had only months earlier eschewed the firm's overtures, quickly changed their tune. Chinese investment soon beget American investment.

"It was that crucial piece of Chinese capital that allowed us to survive," Nicholson said. "That's all it took. Now we're a company with 35 employees."

Reflecting a common feeling among his cohorts in Silicon Valley startups, Nicholson insisted that working with Chinese investors does not mean granting Beijing officials access to the coding process. "My American co-founder and I are in control," Nicholson said, noting that Skymind has given up none of the rights to its intellectual property and has made its code "open sourced," which means the code is freely available for cybersecurity experts to inspect, audit and offer suggestions.

But Bryan Ware, CEO of Haystax Technology, which works with law enforcement, defense and intelligence clients on securing their technologies, cast some doubt on the idea that the owners of tech startups would naturally refuse to share details of their technology with

their investors: "If you've got a Chinese investor and that's the lifeblood that's going to allow you to get your product out the door, or allow you to hire your next developer, telling them, 'No, you can't do that,' or, 'No you shouldn't do that,' while you have no other alternatives for financing — that's just the nature of the dilemma."

"Every investment comes with a risk of some loss of intellectual property or foreign influence and control," Ware said.

And too many Silicon Valley deals exist in a "netherworld" between passive investment and absolute takeover, "where there's access to information, technical information, [and] there is the ability to influence and potentially coerce management," according to the senior Treasury Department official.

One major concern among specialists like Ware is that Beijing officials could use early Chinese investments in next-generation technology to map the software the federal government and even the Defense Department may one day use — and perhaps even corrupt it in ways that would give China a window into sensitive U.S. information.

A POLITICO review of 185 tech startups with Chinese investors found just over 5 percent had received government contracts, loans or grants ranging from a few thousand dollars to several million dollars. Often, the contracts simply involved research — renewable energy for the Energy Department, electronics and communications equipment for the Pentagon, space technology for NASA. Others ordered lab equipment for the Commerce Department, or machine tools for the military.

"There's a tremendous amount of intelligence value there," Ware said. "All governments desire to know what other governments are doing. And knowing the technologies and how they work I think is a big part of that."

While there's no indication that the firms had U.S. government contracts at the time that Chinese investors became involved, that may be part of China's strategy. Derek Scissors, who manages the American Enterprise Institute's China Global Investment Tracker, an exhaustive database of China's major global investments, said that as welcome as the surge of Chinese-funded deals may be in Silicon Valley, the engine behind them is the Chinese government. China's Silicon Valley investment strategy "was shaped by the state and that shaping has gotten tighter," he said.

Still, many Chinese investments in the United States are not directly backed by the Beijing government, but it can be hard to distinguish.

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Some prominent Chinese VC firms in Silicon Valley have clear links to the government. Westlake Ventures, for example, received funding from the government in the coastal Chinese city of Hangzhou, according to media reports and a Pentagon research paper. And Westlake has put money into other VC funds, such as the WI Harper Group, which has a stake in a wide slate of American tech companies, from a dating app to a three-dimensional imaging company to a maker of robot cooks. Westlake did not respond to a request for comment.

But it's not always easy to trace the money back to a single source, let alone determine what connection that source has to Beijing's Communist leadership. Haiyin Capital, a Beijing-based VC firm, is partially backed by a state-run Chinese company, according to a company release. Also complex is ZGC Capital Corporation — located in Silicon Valley and focused on providing startups with basic business help — is a subsidiary of a state-owned enterprise funded by the Beijing government, according to the organizations' websites. Attempts to reach each organization were unsuccessful.

Security and economics experts say they are unsure how much financial or national security harm these Chinese investments are actually causing the United States — if any — simply because it may not be clear for years exactly how important the technology may be.

In the meantime, entrepreneurs in Silicon Valley are blunt: America actually needs Chinese money to maintain its global tech advantage.

"Here's my warning shot," Nicholson said. "If we make it difficult for foreign talent and foreign capital to find each other by over-regulating early-stage startup investing ... we will lose our supremacy as the top tech economy in the world."

Enter Congress

In Washington, Silicon Valley's warning has been heard loudly enough to delay the passage of a bill to strengthen the CFIUS process, despite the support of such bipartisan figures as Cornyn, the second-ranking Senate Republican, and California's own Democratic Sen. Dianne Feinstein, the ranking member of the Senate Judiciary Committee.

Last year, after a cascade of warnings from the Defense Department, Justice Department and other powerful sources, both the House and Senate seemed ready to take action to strengthen oversight of foreign investment in technology companies.

The bipartisan proposal would direct CFIUS to consider whether pending investments would erode America's technological edge, enable a foreign government to utilize digital

spying powers that might be used against the United States, or give sensitive data — even indirectly — to a foreign government. Similarly, it would expand the definition of "critical industries" — a reference to sectors like banking, defense or energy — to include "critical technologies," a significant expansion of the committee's current mandate.

Under the bill, CFIUS would have to create a system to monitor transactions that aren't voluntarily brought to the committee's attention.

The measure would also centralize some of the committee's functions and allow the committee to charge filing fees up to 1 percent of the total value of the transaction up to $300,000, and let Treasury offer a single CFIUS budget request rather than relying on contributions from other departments.

The Trump administration offered a full-throated endorsement of the bill in January, saying it "would strengthen our ability to protect national security and enhance confidence in our longstanding open investment policy."

And while the bill doesn't explicitly cite China, the provisions are clearly aimed at limiting its access to the most sensitive areas.

"Any Chinese-related company that is part of our supply chain is a concern to me," Rep. Robert Pittenger (R-N.C.), a lead House sponsor of the bill, told POLITICO.

Pittenger insisted that Congress' inaction is allowing China to brazenly pilfer the technology that drives America's military might, and sell that technology to adversaries like Iran and North Korea. He noted that a Treasury official told him getting the bill signed is the department's No. 1 legislative priority for 2018.

"We can't turn a blind eye to this," Pittenger said.

But many technology entrepreneurs believe the bill would simply drive cutting-edge research overseas. In 2016, foreign investors injected $373 billion into the United States, a figure that has been mostly increasing since the early 2000s, according to government data. Lengthening the CFIUS review time — currently 30 days, but set to extend to 45 days under the new bill — could damage the "brittle process" of early-stage fundraising, said Nicholson, who encouraged lawmakers to focus on expanding CFIUS powers in other areas, such as bankruptcy courts.

"I worry that they're driving a bulldozer towards a rose garden," said Nicholson, echoing his claim that training the CFIUS lens on Silicon Valley could scare off the very financing

that keeps America growing.

IBM's vice president for regulatory affairs, Christopher Padilla, agreed, warning at a January hearing that the bill "could constitute the most economically harmful imposition of unilateral trade restrictions by the United States in many decades."

He raised particular concerns about expanding CFIUS authority to cover foreign investments in "critical technologies," a phrase tech leaders say is worryingly opaque and that could force companies peddling sensitive technology to have every single sale reviewed.

Padilla called it a "we'll know it when we see it" approach to regulating that "would be deeply damaging to U.S. competitiveness, and, more important, could lead to a false sense of security."

Some industry groups have suggested that the bill should delineate these technologies — robotics or artificial intelligence, for instance — to avoid having every deal scrutinized from top to bottom.

"We would be well served to define those issues from the outset," said Dean Garfield, CEO of the Information Technology Industry Council, a trade group representing industry heavyweights such as Amazon, Apple, Facebook, Google, Microsoft and Twitter. Garfield said getting the bill revised is a top-five issue for ITI in 2018.

He cautioned that the bill, as written, could spike the number of annual CFIUS reviews from "a few hundred deals" to "a few thousand."

Proponents, however, feel that specifying specific technologies might be impossible. The software powering the country — from waterways to missile systems — is constantly changing and evolving, they say. Instead, they suggest, new CFIUS funds and a streamlined reporting process would help keep the growing stream of deal reviews moving.

"For the price of a single B-21 bomber, we can fund an updated CFIUS process and protect our key capabilities for several years," Cornyn said at a hearing. "That is a down payment on long-term national security."

Nonetheless, lawmakers have been working to address industry complaints, making tweaks to the legislation. And just last week, lawmakers made a breakthrough, agreeing to slightly narrow the bill's scope, raising the chances the measure will make it to the president's desk.

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The House and Senate are scheduled to mark up their respective CFIUS bills on Tuesday, and lawmakers now are angling to attach the legislation to the annual, must-pass defense authorization bill as a way to guarantee it gets through. But lingering disputes could still derail the process.

National security leaders and lawmakers warn that these squabbles, while reflecting sincerely held positions, are simply delaying necessary action. At that January hearing, Cornyn described a changing reality if CFIUS is left in its current iteration.

"Just imagine if China's military was stronger, faster and more lethal," Cornyn said.

"That is what the future likely holds," he added, "unless we act."

CRS: The Committee on Foreign Investment in the United States (CFIUS)

James K. Jackson, Specialist in International Trade and Finance, June 27, 2018

Summary

The Committee on Foreign Investment in the United States (CFIUS) is an interagency body comprised of nine Cabinet members, two ex officio members, and other members as appointed by the President, that assists the President in overseeing the national security aspects of foreign direct investment in the U.S. economy. While the group often operated in relative obscurity, the perceived change in the nation's national security and economic concerns following the September 11, 2001, terrorist attacks and the proposed acquisition of commercial operations at six U.S. ports by Dubai Ports World in 2006 placed CFIUS's review procedures under intense scrutiny by Members of Congress and the public. Prompted by this case, some Members of Congress questioned the ability of Congress to exercise its oversight responsibilities given the general view that CFIUS's operations lacked transparency. The current CFIUS process reflects changes Congress initiated in the first session of the 110th Congress, when the House and Senate adopted S. 1610, the Foreign Investment and National Security Act of 2007 (FINSA). In the 115th Congress, the House and Senate adopted measures that would mark the most comprehensive reform of CFIUS since FINSA in 2007 (S. 2098/H.R. 5841, the Foreign Investment Risk Review Modernization Act of 2017).

Generally, efforts to amend CFIUS have been spurred by a specific foreign investment transaction that raised national security concerns. Despite various changes to the CFIUS statute, some Members and others are questioning the nature and scope of CFIUS's reviews. The CFIUS process is governed by statute that sets a legal standard for the President to suspend or block a transaction if no other laws apply and if there is "credible evidence" that the transaction threatens to impair the national security, which is interpreted as transactions that pose a national security risk.

The U.S. policy approach to international investment traditionally has been to establish and support an open and rules-based system that is in line with U.S. economic and national security interests. The current debate over CFIUS reflects long-standing concerns about the impact of foreign investment on the economy and the role of economics as a component of national security. Some Members question CFIUS's performance and the way the Committee reviews cases involving foreign governments, particularly with the emergence of state-owned enterprises. Some policymakers have suggested expanding CFIUS's purview to include a broader focus on the economic implications of individual foreign investment transactions and the cumulative effect of foreign investment on certain sectors of the economy or by investors from individual countries. Changes in U.S. foreign investment policy have potentially large economy-wide implications, since the United States is the largest recipient and the largest overseas investor of foreign direct investment. To date, only five investments have been blocked by previous Presidents, although proposed transactions may have been terminated by the firms involved in lieu of having a transaction blocked. President Obama used the FINSA authority in 2012 to block an American firm, Ralls Corporation, owned by Chinese nationals, from acquiring a U.S. wind farm energy firm located near a DOD facility and to block a Chinese investment firm in 2016 from acquiring Aixtron, a Germany-based firm with assets in the United States. In 2017, President Trump blocked the acquisition of Lattice Semiconductor Corp. by the Chinese investment firm Canyon Bridge Capital Partners; in 2018, he blocked the acquisition of Qualcomm by Broadcom.

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Statement Before the

Senate Foreign Relations Committee

Subcommittee on Multilateral International Development, Multilateral Institutions, and International Economic, Energy, and Environmental Policy

"A Multilateral and Strategic Response to International Predatory Economic Practices"

A Testimony by:

Matthew P. Goodman

William E. Simon Chair in Political Economy

Center for Strategic and International Studies (CSIS)

May 9, 2018

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Introduction

Mr. Chairman, Mr. Ranking Member, Members of the Subcommittee, thank you for this chance to offer my thoughts on how the United States can respond strategically to practices in the international economy that pose a threat to U.S. interests.

Let me begin by commending the Subcommittee for highlighting—through this hearing and S.2757, the National Economic Security Strategy Act of 2018, co-sponsored by the Chairman and Ranking Member—the strategic role of economics in foreign policy and national security. Economics is often an uncomfortable topic for foreign policy experts, who prefer to leave these complex issues to finance or trade practitioners. But economic statecraft is a vital part of the diplomatic toolkit and can serve a country's broad strategic ends—from positive ones like advancing a rules-based order to more sinister ones like coercing smaller countries to follow a larger country's will. Enhancing understanding of "strategic economics"—America's and other countries'—is essentially the mission statement of my program at CSIS, and I welcome the opportunity to lay out some of my thinking on the subject today.

Strains on U.S. Economic Leadership

Since World War II, the United States has been the principal architect and champion of a rules-based international economic order. The order was founded on principles of market-based growth and development, free and open trade, and the rule of law. It was supported by international institutions created in the wake of world war and designed to prevent its recurrence, such as the International Monetary Fund (IMF), World Bank, and World Trade Organization (WTO). The order delivered rising prosperity across the globe unprecedented in human history.

Today, the international economic order—and U.S. leadership of it—is under stress. In the United States itself and other advanced economies, the order is viewed as having failed to deliver the kind of strong growth and shared benefits that it did in the decades following World War II. Externally, the order is under assault from new powers that are unhappy with a system of global governance established by advanced countries when the new challengers were weak.

The China Challenge

Among the new powers, China poses a unique and fundamental challenge to the United States. The relationship between the two countries is complex. On one hand, they are intertwined by trillions of dollars of two-way flows of trade and investment. Total U.S.-China bilateral trade exceeds $600 billion and, by one estimate, inbound investment supports 2.6 million jobs in the United States across a range of industries.[1] The United States and China also share overlapping interests in ensuring a stable, growing global economy and addressing transnational threats, from terrorism to health pandemics to climate change.

[1] Wayne M. Morrison, "China-U.S. Trade Issues," Congressional Research Service. April 16, 2018. Accessed May 07, 2018. https://fas.org/sgp/crs/row/RL33536.pdf.

On the other hand, the United States and China are economic competitors—and increasingly so as the Chinese economy approaches the size of America's. Despite its nominal commitment to market-driven economics, the Chinese party-state continues to exercise a dominant role in the economy and society. Externally, China is a member of the main institutions of global economic governance, such as the WTO, World Bank, and IMF, but is dissatisfied with the balance of power in those institutions and increasingly willing to bend or break their rules to advance China's interests.[2] Beijing has also begun to set up alternative institutions such as the Asian Infrastructure Investment Bank (AIIB) and New Development Bank (NDB or so-called "BRICS Bank").

Under President and Communist Party leader Xi Jinping, Beijing has slowed or reversed earlier steps toward reform and opening of its economy. It continues to restrict access to the Chinese market and to limit competition for foreign companies operating in the country through a combination of measures, from equity caps on investment to regulatory harassment. Foreign companies are often forced to surrender important intellectual property and engage in joint ventures as a condition for market access. Beijing also provides generous domestic subsidies, easy access to credit, and state-backed investment funds to support the growth of Chinese industries.[3] These unequal conditions have helped Beijing establish national champion firms—both state-owned and nominally private—that are increasingly competitive with U.S. firms in China and have begun to compete for market share in third countries.

Since 2015, these efforts have been guided by "Made in China 2025," the country's ambitious plan to capture dominant positions for Chinese producers in 10 advanced sectors, from aerospace to robotics to biotechnology.[4] As discussed below, the fact that China has ambitions to move up the value chain in key industries of the future is not surprising; in fact, it is a rational and legitimate goal for Chinese policymakers as they seek to improve economic outcomes and avoid the so-called "middle income trap." The problem is the tools China is using to achieve this objective: heavy state subsidies that distort competition, forced technology transfer and outright theft from foreign companies, and restrictions on the competitive playing field in China, leading to imbalances in China's trading and investment relationships with the rest of the world.[5] Made in China 2025 represents a significant challenge to U.S. economic interests; by one calculation, almost half of all U.S. manufacturing exports to China are in sectors targeted by the plan.[6] If China's plans to achieve sectoral dominance outlined in Made in China 2025 depend on breaking

[2] Ikenberry, G. John, and Darren Lim, "What China's institutional statecraft could mean for the international order," *Order from Chaos*, Brookings Institution. April 13, 2017. https://www.brookings.edu/blog/order-from-chaos/2017/04/13/what-chinas-institutional-statecraft-could-mean-for-the-international-order.
[3] Wu, Kane. "Exclusive: Chip Wars - China Closing in on Second $19 Billion..." Reuters. April 26, 2018. Accessed May 07, 2018. https://www.reuters.com/article/us-china-trade-fund-exclusive/exclusive-chip-wars-china-closing-in-on-second-19-billion-semiconductor-fund-sources-idUSKBN1HX191.
4 Kennedy, Scott. "Made in China 2025." The New Southbound Policy. Center for Strategic and International Studies. June 1, 2015. Accessed May 07, 2018. https://www.csis.org/analysis/made-china-2025.
U.S. Chamber of Commerce "Made in China 2025: Global Ambitions Built on Local Protections." March 16, 2017. https://www.uschamber.com/sites/default/files/final_made_in_china_2025_report_full.pdf.
[6] Setser, Brad, "The Rising Bilateral Deficit with China and the Negotiations Over China 2025." *Follow the Money*. Council on Foreign Relations. May 03, 2018. Accessed May 07, 2018. https://www.cfr.org/blog/rising-bilateral-deficit-china-and-negotiations-over-china-2025.

the rules and distorting global trade and investment relationships, these efforts must be opposed at both national and multilateral levels.

Beijing has also pursued assertive economic policies abroad to advance its economic and geostrategic interests. Some of these efforts have been coercive; others more complex in motivation and effect. On one hand, China has leveraged its economic size and purchasing power to intimidate smaller states into pursuing policies better aligned with Chinese strategic interests. A notable example was China's attempted economic coercion of South Korea over the deployment of the U.S.-built Terminal High Altitude Area Defense (THAAD) missile-defense system in 2017.[7] Other countries, from the Philippines to Norway, have also been subject to Chinese coercive diplomacy in recent years.

At the same time, Beijing has launched an ambitious plan to build connectivity infrastructure across the globe under the rubric of its Belt and Road Initiative (BRI). In part this plan is designed to offload excess capacity in Chinese infrastructure-related sectors like construction, steel, and cement. Some BRI projects could produce broader economic benefits in terms of local development and expanded trade. But BRI also runs the risk of producing a dangerous rise in debt levels in vulnerable emerging economies (a warning recently echoed by IMF Managing Director Christine Lagarde)—and potentially a loss of sovereignty for the countries involved.[8] It was this set of risks that led former Secretary of State Rex Tillerson to coin the phrase "predatory economics" to describe Chinese practices in an October 2017 speech at CSIS.[9] Meanwhile, there are concerns that strategically placed ports and other infrastructure projects built under the BRI banner could become the basis for Chinese military power projection.[10]

Responses to Date

Since the opening with China in 1972, the approach of successive U.S. administrations to bilateral relations has been to engage with Beijing to elicit cooperation where possible and manage competition where necessary. The Trump Administration has chosen a more confrontational approach in some areas but in practice has, like its predecessors, pursued some mix of cooperation (e.g., on North Korea) and competition (especially on trade and investment).

[7] Glaser, Bonnie S., Daniel G. Sofio, and David A. Parker. "The Good, the THAAD, and the Ugly." *Foreign Affairs*. Council on Foreign Relations. March 17, 2017. Accessed May 07, 2018. https://www.foreignaffairs.com/articles/united-states/2017-02-15/good-thaad-and-ugly.

[8] Lagarde, Christine. "Fix the Roof While the Window of Opportunity Is Open: Three Priorities for the Global Economy." International Monetary Fund. April 11, 2018. Accessed May 07, 2018. https://www.imf.org/en/News/Articles/2018/04/09/spring-meetings-curtain-raiser-speech.

[9] Tillerson, Rex. "Defining Our Relationship with India for the Next Century: An Address by U.S. Secretary of State Rex Tillerson." The New Southbound Policy. Center for Strategic and International Studies. October 18, 2017. Accessed May 07, 2018. https://www.csis.org/events/defining-our-relationship-india-next-century-address-us-secretary-state-rex-tillerson.

[10] Funaiole, Matthew P., and Jonathan E. Hillman. "China's Maritime Silk Road Initiative: Economic Drivers and Challenges." The New Southbound Policy. Center for Strategic and International Studies. April 23, 2018. Accessed May 07, 2018. https://www.csis.org/analysis/chinas-maritime-silk-road-initiative-economic-drivers-and-challenges.

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Recent administrations have used a range of bilateral, regional, and global tools to address economic differences between the two countries. These include:

Bilateral

- Since the opening of bilateral relations, all administrations have set up some kind of formal process for managing economic differences and pursuing opportunities for deeper economic ties. There has been a succession of high-level dialogues, from the Joint Economic Commission (JEC) set up in the Reagan Administration to the Comprehensive Economic Dialogue (CED) briefly established but then suspended by the Trump Administration. These forums have involved enormous commitments of high-level U.S. government attention, and the tangible outputs have been few and far between, but the forums have served a useful purpose in building habits of cooperation and serving as a pressure valve for tensions in bilateral relations.

- The Bush and Obama administrations also devoted consider time and energy trying to negotiate a bilateral investment treaty (BIT) with China to liberalize and create more certainty in direct investment flows between the two countries. These negotiations bogged down over a range of difficult issues and have effectively been abandoned by the Trump Administration.

- There have also been more forceful efforts to respond bilaterally to problematic Chinese economic practices, from direct pressure at the presidential level (e.g., President Obama's personal démarche to President Xi Jinping not to allow cyber-enabled theft of U.S. trade secrets); to blocking of sensitive acquisitions (Ant Financial-MoneyGram); to sanctions against individual companies (ZTE). These have been effective in getting Beijing's attention and arguably modifying Chinese behavior, but by their nature these interventions can only be used episodically.

- The Trump Administration has revived a number of trade remedies under U.S. law, including Section 201 safeguards, Section 232 national security provisions, and Section 301 procedures to deal with discriminatory and burdensome foreign practices. These are legitimate tools but, as discussed below, must be used judiciously to avoid causing undue harm to the U.S. economy, our allies, or the international rules-based order.

Global

- Successive administrations have also worked across a range of international institutions to manage competition with China. These efforts have included the filing of trade cases at the WTO, most recently in March 2018 over China's forced technology practices. For all the flaws and delays in WTO dispute-settlement procedures, the United States has won most of the cases it has filed against China, and this remains an important part of the

economic policy toolkit.[11]

- Administrations have also worked through the IMF, multilateral development banks (MDBs), and less formal organizations like the G20 and G7 to shape rules and norms that, by design or effect, have worked to improve or constrain Chinese behavior in the international economy. While Beijing has chafed at the governance structure of these organizations, it has so far generally acceded to the substantive rules and procedures of existing institutions, again making these useful tools of U.S. economic statecraft.

Regional

- In the region of the world where U.S. and Chinese interests most directly collide—the Asia-Pacific (the Trump Administration prefers to use the term "Indo-Pacific")—U.S. policy over the past several administrations has been focused on promoting trade and investment liberalization and establishing rules and norms that were partly designed to shape Chinese economic behavior.

- Since 1989, the Asia-Pacific Economic Cooperation (APEC) forum has been the principal venue for advancing these objectives. APEC's non-binding, consensus-based approach to decision-making can be tedious and deliver few tangible short-term results, but the forum has resonance in an Asian context and has proven over time to play a useful role in promoting U.S.-preferred norms.

- At the heart of Asia-Pacific—and effectively China—economic strategy in both the Bush and Obama administrations was the Trans-Pacific Partnership (TPP). This mega-regional trade agreement brought together 12 Asia-Pacific countries representing 40 percent of global GDP to slash tariffs and non-tariff barriers to trade and establish high-standard rules to govern the regional trading system in important areas such as the digital economy, state-owned enterprises, and labor and environment standards. As I have argued before, TPP had a powerful effect on Chinese thinking about its own economic strategy—mostly a positive effect from a U.S. perspective.[12] But TPP became the victim of a contentious U.S. presidential election in 2016 and—in one of the most consequential (and in my view ill-advised) policy decisions of his presidency—President Trump withdrew from the deal on his third day in office.

Key Elements of Successful Economic Statecraft

Individually these bilateral, global, and regional approaches by recent administrations have been more or less effective, as discussed above. Missing so far in the Trump Administration's approach is a comprehensive international economic strategy that would have a broader effect in

[11] Bown, Chad P. "Is the WTO One of Trump's 'big Quagmire Deals'? Here's What's at Stake." *The Washington Post.* February 28, 2017. Accessed May 07, 2018. https://www.washingtonpost.com/news/monkey-cage/wp/2017/02/28/is-the-wto-one-of-trumps-quagmire-deals-heres-whats-at-stake.
[12] Goodman, Matthew P. "Chapter 2: Going on the Offensive." *Meeting the China Challenge: Responding to China's Managed Economy.* January 2018. Accessed May 7, 2018. https://csis-prod.s3.amazonaws.com/s3fs-public/publication/180126_Lewis_MeetingChinaChallenge_Web.pdf?ccS38O06FR8XG_yUn7GS1YrJXOTCZklM.

shaping Chinese actions in a way favorable to U.S. interests. What follows are, in my view, some of the key elements of an effective strategy.

Fact-based analysis
Smart economic strategy starts with cool-headed analysis of the challenges and opportunities that face the United States. There has been a tendency among Washington analysts recently to dismiss the benefits of economic engagement with China over the past 40 years and to exaggerate the current threat.[13] The fact is that the United States has seen enormous benefits economically from the rise of 600 million Chinese to the middle class and from the trillions of dollars of trade and capital that now flows between the two countries. To be sure, these aggregate benefits have come with distributional costs for many American workers and communities; and, as enumerated above, many Chinese economic policies and plans today are deeply problematic for U.S. interests.[14] But this is no excuse for revisionist history that brushes past the undeniable benefits of U.S.-China economic engagement over the past four decades, or the continued opportunities in the relationship today.

We should also be careful not to view all aspects of Chinese economic strategy as equally threatening to U.S. interests. China has reached the limits of a 40-year-old development model based on low-value-added production. As mentioned earlier, it is no surprise that it wants to move up the value chain or has plans to succeed in new industries such as electric vehicles and advanced biotechnology. The problem is not so much *what* Beijing is doing as *how* it is doing it—via subsidies, forced technology transfer, restrictions on competition, and other discriminatory policies. Rather than signaling opposition to China's development objectives, the United States should be focused on forcing China to abandon or modify its problematic policies and to level the playing field for American companies.

Moreover, China is not as capable or coordinated as it appears to many outsiders, and it is far from certain that Beijing will be able to pull off its ambitious plans. The country faces an array of daunting challenges, from managing escalating debt to staving off environmental catastrophe. China needs to pull off the rare feat of breaking out of the middle-income trap while dealing with a rapidly aging population.[15] As CSIS documented in a report a few years ago, the Chinese government is notoriously compartmentalized and uncoordinated, both among central ministries and between Beijing and local levels of government.[16] Xi Jinping's attempt to assert greater

[13] Campbell, Kurt M., and Ely Ratner. "The China Reckoning: How Beijing Defied American Expectations." *Foreign Affairs*. Council on Foreign Relations. February 28, 2018. Accessed May 07, 2018. https://www.foreignaffairs.com/articles/united-states/2018-02-13/china-reckoning.
[14] Autor, David H., David Dorn, and Gordon H. Hanson. "The China Shock: Learning from Labor Market Adjustment to Large Changes in Trade." National Bureau of Economic Research. University of Chicago Press. January 2016. Accessed May 07, 2018. http://www.nber.org/papers/w21906.
[15] "China 2030: Building a Modern, Harmonious, and Creative Society." Development Research Center of the State Council, the People's Republic of China. The World Bank. 2013. Accessed May 7, 2018. http://www.worldbank.org/content/dam/Worldbank/document/China-2030-complete.pdf.
[16] Goodman, Matthew P., and David A. Parker. "Navigating Choppy Waters: China's Economic Decisionmaking at a Time of Transition." CSIS Simon Chair in Political Economy. Center for Strategic and International Studies. March 2015. Accessed May 7, 2018. https://csis-prod.s3.amazonaws.com/s3fs-public/legacy_files/files/publication/150327_navigating_choppy_waters.pdf.

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party control of economic affairs may produce better coordination of policy, but it is likely to come at the expense of lost initiative and slower progress toward its development goals.

None of this is an argument for complacency; the challenges are real. But a U.S. strategy based on the premise that almost everything China does is a threat—or is bound to succeed—is itself likely to fail. Not only will we squander opportunities to serve a growing market of 1.4 billion consumers, or to win Chinese cooperation on shared concerns like terrorism and climate change; but we are also likely to target the wrong risks and fail to counter the ones that really matter. The Obama Administration's handling of the AIIB launch in 2015 is a case in point: by implying that the United States was outright opposed to the initiative and working to kill it, the Administration turned the spotlight back on U.S. behavior rather than on legitimate governance and operational questions about the new bank. Similarly, if the Trump Administration gives the impression that its "free and open Indo-Pacific" strategy is primarily designed to counter China's Belt & Road Initiative, the United States will "lose the room," since most developing countries in Asia and beyond want—or at least feel they *need*, in the absence of alternatives—Chinese-financed infrastructure. Instead, we should be focused on specific concerns like debt sustainability and procurement practices that disadvantage competitors to Chinese companies abroad, to the detriment of recipient countries as well as the United States.

Playing offense and defense

In addition to being based on clear-eyed analysis, a successful economic strategy must contain both offensive and defensive elements. Every baseball fan knows that winning consistently requires both great pitching and great hitting. As suggested earlier, there is a worrisome tendency in Washington to focus primarily on threats and the defensive policies needed to ward these off, potentially missing opportunities and imposing costs on our own interests that outweigh the benefits.

The United States certainly needs to defend our interests against harmful foreign policies and practices, including by China. This includes "protecting the crown jewels," i.e., ensuring that critical assets and technology are not lost to strategic rivals through acquisition or cyber-enabled theft. Among other things, this means we need a Committee on Foreign Investments in the United States (CFIUS) that has the resources and analytical tools to screen out foreign investments that genuinely threaten national security. The bipartisan bill submitted last fall by Senator Cornyn (R-TX) and others—S.2098, the Foreign Investment Risk Review Modernization Act (FIRRMA)—is appropriately motivated by this objective. But it is important to avoid broadening the scope of CFIUS review so wide that it creates two unintended consequences: first, overloading the process with thousands of cases that causes CFIUS to miss the most serious threats to national security; and second, having a chilling effect on foreign direct investment more broadly, which has been an overwhelmingly positive force for growth and employment in the United States.

Also on the defensive side of the ball, Washington needs to brush Beijing back when it pursues economic policies that harm our interests or damage the rules-based order. We should use all legitimate tools available—U.S. trade remedies; WTO dispute settlement procedures; tough, results-oriented bilateral negotiations—to protect our economic interests and defend a rules-

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based order that has served us well for 70 years. But again, we need to be smart about how we do this, spending our time and political capital on foreign practices that are most harmful to long-term U.S. interests. This means targeting Chinese government subsidies, forced technology transfer, and restrictions on competition that, as discussed above, bolster the Made in China 2025 plan. By contrast, trying to reduce the bilateral trade deficit through large Chinese purchases or export restraints is likely to produce at best temporary gains as long as deeper macroeconomic forces remain at play; at worst, it will create further distortions in the global system that could potentially harm the United States and our allies.

Second, we need to use the right tools—and use them judiciously. Unilateral tariffs are likely not only to impose heavy costs on our consumers and downstream businesses, but also to violate our international obligations, do harm to the rules-based order, and punish key allies like Japan and the European Union that are critical to addressing a shared challenge from China.

This leads to the other side of an effective economic strategy: smart offense. The United States needs a positive economic agenda that pulls allies and partners into collaborative work to promote growth around the world, open markets, and create high-standard rules of the road for the international economy. Working with like-minded countries in this way helps spread U.S.-preferred rules and norms and offers an alternative to the more statist Chinese approach. This was the organizing principle behind TPP and the Transatlantic Trade and Investment Partnership (TTIP), two mega-regional trade deals pursued by the Obama Administration but effectively abandoned by President Trump early in his term.

In the absence of initiatives like TPP and TTIP, the United States needs to find other tools on the offense side of the strategic economic game. The Trump Administration is on the right track in calling for a "free and open Indo-Pacific" (FOIP) in that critical part of the world. While still missing many details—including a credible trade strategy to replace TPP—the FOIP initiative contains two promising strands: creating alternative financing mechanisms to China's largesse in the region through BRI; and working in the World Bank, Asian Development Bank (ADB), and other multilateral institutions to promote high-quality infrastructure investment. The former has taken shape in the form of efforts to create a new Development Finance Corporation (DFC) with more resources and authorities (e.g., to take equity positions in large projects). The latter has been boosted by the Administration's recent decision to support a capital increase at the World Bank. Both of these strands of work should be supported and extended.

Two other areas for further work include pulling China into international arrangements that would help to constrain their problematic behavior. China is not a member of the Organisation for Economic Cooperation and Development (OECD), the club of advanced economies that agrees on codes of conduct in areas such as export credits and non-corrupt practices. These codes are not binding on members but use moral suasion to create a more level playing field in the international economy. Whether by pulling China into the OECD or extending these disciplines through other means, China's practices in these areas could be brought in better alignment with international norms.

China is also not a member of the Paris Club, the informal gathering of creditor countries to coordinate solutions to payments problems by debtor nations. As mentioned earlier, concerns have been mounting about the sustainability of debt burdens in certain low-income and emerging countries that have been targets of Chinese largesse, including through BRI. Beijing has resisted signing on to well-established rules of the road when it comes to avoiding unsustainable lending and addressing debt problems when they arise,[17] including joining the Paris Club. Membership would require China to share information, including on financing terms, with other Paris Club members, as well as grant "comparability of treatment" with all bilateral creditors. It would also demonstrate China's willingness to play by the rules rather than seek advantage at the expense of debtor nations and other official creditors.

Whole of government, whole of nation

Smart economic statecraft draws on all the resources of the U.S. government—and beyond. This begins with the President, who must put a visible priority on the strategic economic dimension of foreign policy and national security, including through a Presidential Policy Directive or equivalent statement. He should task the National Security Council and National Economic Council—working seamlessly together, including through co-reporting lines of relevant senior officials—with establishing a robust interagency process for development and implementation of an international economic strategy. They should pull in all relevant agencies—not just ones with an obvious economic focus like Treasury, Commerce, and Office of the U.S. Trade Representative, but also the State Department, which is a key player in economic diplomacy.[18] And of course the White House needs to have robust processes for coordinating with Congress on these issues.

It is not just the Federal government that needs to contribute to a successful economic strategy. Washington needs to do more to coordinate with states and cities, which are most directly impacted by both the opportunities and risks of economic ties with China. Washington also needs to leverage the private sector better, for example in shaping an effective response to BRI.

Rebuilding domestic foundations

Finally—and arguably more important than another element—we need to invest in ourselves. A strong, competitive economy is the essential foundation for a successful international economic strategy. We need to rediscover the winning formula that brought us such success in the postwar period: modern infrastructure, education and skills training to prepare workers for the new economy, and investment in basic research and development critical to leadership in industries of the future.

At the moment we are failing in all these areas. As other nations race ahead to build new infrastructure, ours remains vastly underfunded and continues to deteriorate. A McKinsey report

[17] Hurley, John, Scott Morris, and Gailyn Portelance, "Will China's Belt and Road Initiative Push Vulnerable Countries into a Debt Crisis?" Center for Global Development. March 05, 2018. Accessed May 07, 2018. https://www.cgdev.org/blog/will-chinas-belt-and-road-initiative-push-vulnerable-countries-debt-crisis.
[18] Goodman, Matthew P. "Downgrading State's Economic Diplomacy." The New Southbound Policy. Center for Strategic and International Studies. June 29, 2017. Accessed May 07, 2018. https://www.csis.org/analysis/downgrading-states-economic-diplomacy.

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from June 2016 estimated that the United States would need to invest more than $150 billion per year between 2017 and 2030 to meet the country's infrastructure needs.[19] Meanwhile, we stand near the top of the OECD in terms of education spending per student, yet ranked 19th in the 2015 PISA rankings of performance in science, reading, and mathematics.[20] And while our private sector fuels the bulk of R&D investment in the United States, as a nation we commit the equivalent of just 0.6 percent to R&D through public spending, less than many other similarly developed nations.[21]

These are areas where CSIS plans to do more work in the period ahead, in an effort to help rebuild domestic support for our international economic engagement.

The Role of Congress

Congress has an important role in crafting and executing a successful international economic strategy. S.2757, co-sponsored by the Chairman and Ranking Member, is a good start. It accurately diagnoses the challenges faced by the United States in the international economy and outlines many of the key elements of a successful strategy. In line with my earlier points about playing both offense and defense, it is important in my view for Congress to ensure that the executive branch, in developing its plan, keep an eye on both threats *and* opportunities in the international economy.

There are other ways Congress can help. First, the U.S. government must be adequately resourced to support an effective economic statecraft. This means sustaining funding not only for economic agencies like the Treasury and Commerce departments and USTR, but also for the lead agency under this Committee's jurisdiction: the State Department. As I have written before, State brings something unique to the U.S. government's international economic policymaking, what I call "reach"; no other agency is present in over 190 countries around the world and able to operate across countries and societies.[22]

Resources also mean people, and the Senate would contribute to an effective economic statecraft by acting as expeditiously as possible to confirm senior officials to key undersecretary, assistant secretary, and ambassadorial positions in the U.S. government; key vacancies at present include

[19] Woetzel, Jonathan, Nicklas Garemo, Jan Mischke, Martin Hjerpe, and Robert Palter. "Bridging Global Infrastructure Gaps." McKinsey Global Institute. McKinsey & Company. June 2016. Accessed May 07, 2018. https://www.mckinsey.com/industries/capital-projects-and-infrastructure/our-insights/bridging-global-infrastructure-gaps.

[20] "PISA 2015: Results in Focus." Organisation for Economic Co-operation and Development. 2018. Accessed May 7, 2018. https://www.oecd.org/pisa/pisa-2015-results-in-focus.pdf.

[21] Boroush, Mark. "U.S. R&D Increased by $20 Billion in 2015, to $495 Billion; Estimates for 2016 Indicate a Rise to $510 Billion." National Center for Science and Engineering Statistics. National Science Foundation. December 14, 2017. Accessed May 07, 2018. https://www.nsf.gov/statistics/2018/nsf18306/.

[22] Goodman, Matthew P. "Downgrading State's Economic Diplomacy." The New Southbound Policy. Center for Strategic and International Studies. May 07, 2018. Accessed May 07, 2018. https://www.csis.org/analysis/downgrading-states-economic-diplomacy.

the Under Secretary of State for Economic Growth, Energy, and the Environment, and the ambassadors to South Korea, Australia, Saudi Arabia, and South Africa.[23]

Congress can also ensure that the other unilateral and multilateral financial tools the United States has in its economic toolkit are fully supported and resourced. We will not be able to compete with China's economic statecraft unless we have fully functioning agencies like the U.S. Agency for International Development (USAID), the U.S. Trade and Development Agency (USTDA), the Overseas Private Investment Corporation (OPIC), and the U.S. Export-Import Bank (EXIM). To be clear, the combined financial firepower of these agencies will never match the trillions of dollars that China is promising to spend through initiatives like BRI. But competing in economic statecraft is not just a function of money; when added to the first-class products and services, non-corrupt practices, and capacity building that American companies bring to their international operations, relatively small amounts of financing from agencies like OPIC and EXIM can produce a winning formula.

Against this backdrop, Congress can also give a boost to U.S. economic strategy through expeditious approval of relevant legislation, including S.2463, the Better Utilization of Investments Leading to Development (BUILD) Act, as well as sensible reforms of CFIUS and the export-control regime. Early approval of the capital increase at the World Bank would also strengthen an important multilateral source of leverage for the United States, including in supporting U.S. efforts in the infrastructure competition in Asia.

Finally, in my view it will be important for Congress to fully assert its constitutional authority over trade in the period ahead. The current administration has worrisome protectionist tendencies that risk doing harm to our economic and diplomatic interests, and it has yet to lay out a coherent trade-negotiating strategy. While supporting a tough line on China's bad behavior in the trade arena, Congress can insist that the administration not do damage to our international obligations or our alliances, and that it come up with a comprehensive and credible trade strategy to open markets and strengthen international rules.

Conclusion

Again, I commend the Subcommittee for shining a light on problematic practices in the international economy today and on the role of "strategic economics" in foreign policy and national security. With the right analysis, tools, and resources—and confidence in our position—the United States can develop and implement an effective economic strategy in response to these challenges.

I thank you for the opportunity to offer my thoughts and look forward to answering Members' questions.

[23] "Trump Nominations Tracker: See Which Key Positions Have Been Filled so Far." *The Washington Post.* Accessed May 07, 2018. https://www.washingtonpost.com/graphics/politics/trump-administration-appointee-tracker/database/?utm_term=.4d8dcfef0840.

Prepared Testimony
of Michael Wessel
before the Subcommittee on Multilateral International Development, Multilateral Institutions, and International Economic, Energy, and Environmental Policy
of
Senate Committee on Foreign Relations
"A Multilateral and Strategic Response to International Predatory Economic Practices"
May 9, 2018

Chairman Young. Ranking Member Merkley. Members of the Committee. I want to thank you for your invitation to appear before you today to discuss a multilateral and strategic response to international predatory economic practices. It is an honor to appear before you.

My name is Michael Wessel and I am appearing before you today wearing two hats: First, as a Commissioner on the U.S.-China Economic and Security Review Commission (China Commission), where I have served since its creation in 2001. Second, as a representative of the AFL-CIO and its 12 million members. But, as a disclaimer, I am speaking for myself, although my comments are informed by my service on the Commission and my work with organized labor over my entire career in Washington.

The Commission was created by Congress in 2001 in conjunction with the debate about the grant of Permanent Normal Trade Relations (PNTR) to China, paving the way for its accession to the World Trade Organization. The Commission was tasked with monitoring, investigating and submitting to Congress an annual report on the national security implications of the bilateral trade and economic relationship between the United States and the People's Republic of China, and to provide recommendations, where appropriate, to Congress for legislative and administrative action.

The grant of PNTR ended the annual debate about whether to extend most favored nation status to China. But even as it passed PNTR, Congress created the Commission because it did not want to forego the annual review of our relationship with China. Since the creation of the Commission, our mandate has been extended and altered as the US-China relationship has evolved.

The Commission is a somewhat unique body: We report to and support Congress. Each of the four Congressional leaders appoint 3 members to the Commission for 2-year terms. In 7 of the last 10 years, we have issued unanimous reports. In the 3 years where it was not unanimous, there was only one dissenting vote. In many ways, the evolving challenges and opportunities posed by the relationship with China have united us in our analysis.

I also serve as the staff chair of the Labor Advisory Committee (LAC) to the USTR and Department of Labor. The LAC is a statutory committee made up of more than 20 unions that provides advice on U.S. trade policy and negotiations. Each of the LAC principals, and their

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liaisons, are cleared advisors and are able to access the text of negotiations, to the extent they are made available, as well as interact with our negotiators and their teams.

These hats offer a 360-view of what is happening in the economy and the intersection of our international and domestic economic policies. While the American people and our producers have unique advantages and capabilities, as well as latent strength, we face enormous pressures in the world. Those pressures are well known to the Members of this Committee.

The title of this hearing is broad and testimony that does justice to its sweep could encompass several volumes. I hope that my thoughts will address some of the key concerns of the Subcommittee and I welcome the opportunity to work with you as you assess these issues.

This hearing comes at a particularly important time. Last week, senior Administration officials were in Beijing to engage their counterparts in seeking to address the predatory and protectionist policies of the Chinese. China stands out in terms of the extensive public pronouncements it has made and actions it has taken to advance its interests and expand its economic and military power and capabilities.

But, while I will focus most of my comments on China, as I have spent considerable time as a Commissioner evaluating their policies, China is not necessarily unique. Its state-led development policies, coupled with a non-market approach, is being emulated by other nations as the benefits of such an approach have become clear, as have the failure of the U.S., and multilateral institutions, to update and reform their approaches. India, Brazil and other countries are taking cues from China.

The Administration is seeking to confront these policies. Needless to say, we can all find fault with how they have approached some of these challenges. But, what we cannot question is the fact that the predatory policies of our trading partners – led by China – must be addressed. Time is growing short in terms of being able to tip the balance back in our favor or at least level-the-playing field, and ensure that market-led policies that will keep America as the world's technological and economic leader and ensure broadly-shared prosperity here at home.

China's leaders have solidified their power and, in turn, the ability to fulfill their plans to become a global technology leader, if not *the* global technology leader in the not-too-distant future. China has well-developed and aggressive plans in this area. Their plans are public and provide a clear roadmap for them to follow, and for us to assess.

Unfortunately, until only the last two years, public policy leaders either largely ignored China's public pronouncements or simply didn't properly assess their competence in, and commitment to, reaching those goals. That has been a huge mistake and has led to rapid advancements by China in ways that have been fueled by U.S. omissions and commissions.

This hearing is also particularly timely in light of the President's actions to confront Chinese policies in the intellectual property arena. The press is writing about the threatened imposition of tariffs by both the U.S. and China, but has not focused sufficiently on the underlying issues that have plagued U.S. businesses, innovators and workers for years. China's actions have had a clear and substantial impact on our productive capacity and the employment of our people. This hearing, in part, will help to shed light on some of those issues.

China is committed to achieving its goals and will engage in legal means if possible, and illegal means if necessary, to achieve those goals. In the Administration's December 2017 *National Security Strategy of the United States of America* document, examples of illegal practices by China were identified as "cyber enabled economic warfare." There are many areas that fall under the jurisdiction of this Subcommittee that bear on China's future success, and ours.

In your invitation letter, you posed a number of questions. I do my best to respond to concisely below:

1. **What sort of Chinese international predatory economic and business tactics do the U.S. and American companies confront (e.g. tactics related to market access, regulatory environments, protectionism, distortive subsidies, foreign ownership, coercive technology transfer, and intellectual property theft)?**

The Chinese government employs a labyrinth of policies, with associated strategies and tactics to advance its economic and national security interests. Indeed, the government views economic and national security policies as inextricably intertwined. The government must support significant levels of economic growth to ensure that their grip on power can be maintained. If growth diminishes, unemployment and dissatisfaction may rise, causing substantial pressures on the government to reform. President Xi has solidified his grip on power with the recent change allowing him to serve more than two terms in addition to steps he has taken to magnify his control and leadership of the People's Liberation Army and the Chinese Communist Party. Cracking down on dissent must be coupled with steps to alleviate economic and social stress and China's economic policies often fulfill those objectives.

China has a coordinated strategy to advance its interests and dominate sector after sector. This is clearly identified in public documents, the most notable being Five Year Plans and the Made in China 2025 plan. That latter plan identifies the goal of becoming close to, if not, self-sufficient in ten key sectors. In several sectors, the government identifies that a majority of the products and services utilized must be developed and produced indigenously. In robotics, for example, the goal is 70% of 2025.

That goal will be achieved in a variety of ways. China's approach is far from perfect. But, as it is a non-market, state-led economy that has amassed trillions of dollars in foreign currency reserves via protectionist and predatory policies – including currency manipulation and misalignment strategies – China can afford to make mistakes.

Many of China's top firms are state-owned. They aren't judged primarily on their ability to turn a profit or on efficient spending but on their ability to fulfill state directives and needs. They have access to low-cost or, indeed, no-cost capital as non-performing loans might be rescheduled or forgiven. They benefit from state procurement preferences, the design of standards either at the government level, or within standards-setting bodies. There are a variety of other supporting policies and programs as well, including direct subsidies, tax abatements, free land and other preferences.

But even firms that want to be considered as "private" aren't free of government's hand – in positive and negative ways. Thilo Hanneman of the Rhodium Group, said at a hearing of the China Commission last year, that "It is difficult to properly classify state-owned entities and the distinction between private and state-owned companies for policy analysis based on nominal equity ownership is problematic. China's state-dominated financial system and the lack of rule of law means that state involvement can be pervasive, even if a firm is nominally privately owned."

And, while the rules change on a regular basis, large outward investments by these firms must be reviewed and approved by the Chinese government. Major investments advance only if they further the interests of the government and the Party. So, for example, in the robotics sector, one of the leading international firms, Kuka, was taken over by China's Midea Group in 2017 to accelerate China's industrial robotics capabilities.

Last year, the China Commission heard testimony as to the possible activities of Chinese actors to diminish the value of acquisition targets prior to purchase. This possibility, if true, raises significant issues that need further attention. As China seeks foreign acquisition targets to enhance its capabilities, if they are engaged in cyber and human espionage activities to reduce the cost and attractiveness of assets it wishes to acquire, it poses a significant threat to our economic and national security interests.

In addition to the network of policies supporting Chinese indigenous production, where needed, China's government supports development and acquisition strategies. This may occur through legal, coercive and illegal means, including cyber and human espionage. In the intellectual property area, this was well-documented by the USTR in its Section 301 report that was the basis for the Administration's recent action against China for IP violations.

But, China also targets U.S. universities, colleges and research institutes to help support its technology programs. China's 111 Program, and its 1,000 Talents Program, is designed to cultivate foreign experts to come to China and help advance Chinese technological and scientific capabilities. The 1,000 Talents Program has an array of benefits including a signing bonus that is roughly equivalent to $158,000.

In addition to the above, China is engaged in a broad array of other predatory practices including dumping and subsidization, forced and coerced technology transfers, the use of unlicensed software, the production of counterfeit copyrighted, patented, and trademarked goods, continuing additions in productive capacity in sectors such as steel and aluminum where there is already

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substantial domestic and global overcapacity, the violation of internationally recognized worker rights, and other practices. China simply does not play by the rules.

2. **Does China provide U.S. companies reciprocal access and treatment? If not, what are the most prominent or significant cases where American companies do not have reciprocal access in China?**

Across a broad range of sectors, China does not provide reciprocal access. Even in those sectors that are supposedly "open" the government often maintains a role in limiting access. From services to technology to aerospace to agriculture, China has a managed economy and engages in managed trade.

China did abide by many of its commitments to lower tariffs in compliance with its protocol of accession to the World Trade Organization. But behind those reduced tariffs are often layer upon layer of protectionist policies. In major sectors, China's leading firms are state-owned entities where foreign competition is severely limited, if not outright prohibited.

In an increasingly informationalized and globalized economy, China's technology restrictions are significant barriers. China's requirements for restrictions on data flows, limits on foreign cloud providers access to the market, requirements that source code be provided by certain players all confound the ability of foreign firms to access and operate on a global basis.

Additionally, access to China's market is often subject to joint venture requirements. Many of these requirements were accepted as part of China's accession agreement – a fundamental flaw of that agreement. But, in other areas, access to the Chinese market does not legally require joint ventures, but it's tough, if not impossible, to access the market without a partner. Often, as was noted in the USTR's Section 301 report, the joint venture partner requires that technology be transferred as a condition of engaging in the partnership.

Last June, the National Development and Reform Commission and the Ministry of Commerce jointly issued the Catalogue of Industries for Guiding Foreign Investment. This catalog replaces the earlier catalog and is designed to identify those sectors where investment is welcomed. The investments are designed to help fill gaps in Chinese capabilities and advance the goals of the 13th Five Year Plan and other government programs. It represents some liberalization from past catalogs but still maintains significant limitations.

In my own view, we have to be careful about the concept of reciprocity as there are many sectors I would argue should not be opened to Chinese state-owned, state-controlled or state-invested enterprises at this point. Even if we were to have China commit to access in their market, it might not be in our own interests to provide such access on a reciprocal basis. And, as is well-documented, Chinese promises are often broken, while the U.S. keeps its promises. The quality of market access, even in an area where we might wish to access the Chinese market, might be substantially undermined by their government policies and practices. This should be done on a case-by-case basis.

As a result, I believe it would be unwise to restart Bilateral Investment Treaty negotiations with China. There is no indication that the Administration is preparing to restart the BIT negotiations but Congress should be aware of the serious peril that exists if BIT negotiations resume.

3. **What are the national security and foreign policy implications of these international predatory economic practices for the U.S.? How have the U.S. government and American companies responded to predatory practices? How should the U.S. respond?**

China has targeted a broad range of industries for development and preferential status in their Five-Year Plans and other policy pronouncements. These range from agriculture to metals to autos to high technology and other sectors. As today's hearing is focused primarily on technology issues, my comments will center around those sectors.[1]

China's *Made in China 2025 Initiative identified 10 key sectors the government would further* support with the goal of fostering Chinese leadership in areas of technology with significant economic and national security implications. They include:

1. New Energy Vehicles
2. Next-Generation Information Technology
3. Biotechnology
4. New Materials
5. Aerospace
6. Ocean Engineering, High-Tech Ships
7. Railway
8. Robotics
9. Power Equipment
10. Agricultural Machinery

Each of these sectors in China has benefited from a whole-of-government approach to ensuring that Chinese companies stake out dominant positions in the global market. And, they are promoting the idea of "national champions": companies that have significant market share and presence in China to dominate the market.

These national champion companies, many of which are state-owned enterprises, are benefiting from strong state funding (including provincial and local level support), foreign talent and technology acquisition, an insulated domestic market and even industrial espionage.[2] China is

[1] See *China's Technonationalism Toolbox: A Primer*, Katherine Koleski & Nargiza Salidjanova, U.S. China Economic and Security Review Commission, March 28, 2018. https://www.uscc.gov/Research/china%E2%80%99s-technonationalism-toolbox-primer

[2] 2017 Annual Report to Congress, U.S.-China Economic and Security Review Commission.

effectively leveraging international openness, particularly that of the U.S. market, academic community and research institutes, to augment domestic capacity and capabilities with the ultimate goal of self-sufficiency in advanced technologies.

In the case of the next generation of electric vehicles (EVs), the Chinese government has sought to secure global leadership in EVs through the use of significant state-support in production and infrastructure, overseas acquisitions and the use of state-sponsored incentives to artificially boost domestic demand. Identified in the Made in China 2025 strategy, EV production has been the recipient of hundreds of billions of dollars in subsidies at the central, provincial and local government levels.[3] EV charging stations have been provided additional subsidies to meet the goal of 12,000 stations being installed in China by 2020.[4] Yet, while investing billions of dollars in fostering the industry, the Chinese government has insulated the market from foreign competition.

Out of the gate, any foreign-made automobile entering China is subject to a 25% tariff, however; if a foreign company agrees to form a joint-venture with a Chinese counterpart, and agrees that any EVs sold will be sold under a Chinese brand, that tariff can be waived.[5] Yet, these joint-ventures often require that technology be transferred and raise threats of intellectual property theft.

In 2015, the U.S. and China each sold roughly 190,000 EVs. One year later, China's sales grew to over 350,000 EVs, eclipsing U.S. leadership.[6] China's use of non-market economy tactics has led to its successful rise to the position of global leader in EV production, to the detriment of foreign competitors forced to compete on a massively uneven playing field. China's approach to EVs is only one, of many examples of the nation's state-dominated economic system that has wreaked havoc on American producers and their workers over the last 17 years.

When China joined the World Trade Organization in 2001, many economists overestimated or, indeed, were limited by ideological blinders in thinking China would just continue to compete against the U.S. in low-value products likes toys and textiles. Last year, China ran a surplus in Advanced Technology Products trade (ATP) with the U.S. of $135.3 billion. The quantity and composition of our trade with China has changed dramatically since 2001.

Some of China's advances are the result of U.S. naiveté and policy mistakes.

The U.S. has essentially failed to address Chinese industrial policies since its membership in the WTO. Before that, as early as the mid-1990s, the U.S. took only limited acts against Chinese intellectual property rights violations. Over the years, several memorandums of understanding were signed between our two countries meant to throttle back some of China's policies. But,

[3] November, 2017, Economics and Trade Bulletin, U.S.-China Economic and Security Review Commission, https://www.uscc.gov/sites/default/files/Research/November%202017%20Trade%20Bulletin.pdf
[4] Ibid
[5] Ibid
[6] Ibid

their illegal acts continue and, indeed, increased in effectiveness. The China Commission has tracked these mistakes over the years. Numerous public and private reports have documented these violations as well as these industrial policies and their cost to the U.S. in terms of production, jobs and lost economic benefits.

The U.S. was naïve in thinking that China wanted to be just like us when it acceded to the WTO. Those who supported China's accession viewed the commitments from a "Western", free market, rule-of-law perspective. China simply had and retains a different view of what its commitments meant or, perhaps, simply had no intention of abiding by the promises they were making.

America's lopsided trade relationship with China has also fueled China's development and advances in the science and technology arena. Since China joined the WTO, the U.S. has amassed an accumulated merchandise trade deficit of roughly $4.3 trillion. That is a transfer of wealth. It has allowed China to make massive investments in its future – many of which are to our nation's disadvantage.

U.S. multinational companies have responded to Chinese policies and practices in a variety of ways. During the "honeymoon" period after Chain's accession to the WTO in 2001, companies flocked to China with the hope of accessing its more than 1 billion consumers. Of course, there were successes. But, over time, Chinese companies – often as joint venture partners – were able to harvest the benefits and learning from those relationships, to advance their own interests.

This led to the next phase of responses where multinational companies began to question the long-term value of their operations there. Many were still hopeful and continued to invest. Many were coerced with the perceived "threat" of lost sales if they did not invest. Others continued to flock to China with no intention of selling to the Chinese market—but solely to take advantage of cheap production methods and produce for the U.S. market. Still other companies chose, in the light of their concerns, and rising intellectual property theft, to limit the technologies they transferred to second and later-generation activities.

At the same time, China was beginning to "squeeze" foreign companies through a variety of efforts including stricter rules relating to data transfers, competitive activities and other areas. During this period, China continued to promote export-led growth and foreign invested enterprises found that China could serve more as an export platform than as a market opportunity. Recent data indicated that 46% of Chinese exports emanated from foreign-invested enterprises. This was directly counter to the interests of U.S. domestic producers and their workforce.

Of course, many companies chose to double-down on their operations and relationships with China. General Electric, for example, engaged in a joint venture with AVIC, one of China's state-owned aerospace firms, transferring avionics technology. China is now poised to become a world leader aerospace leader with the ARJ-21 and Comic's C-919 which have taken

advantage of U.S. technology. In addition, China's use of offsets has pressured other aerospace firms to transfer production to China to ensure that they are able to sell their products there.

These and many other Chinese practices have largely gone unchallenged by the U.S. Private sector petitions on dumping and subsidies have led the way in addressing those practices. Despite our government having the authority to self-initiate action under these authorities, only one case – against aluminum products – was lodged during the past 20 years.

In several other areas, it was the petitions of private sector parties that led to challenges to Chinese practices – this occurred with regard to auto parts, green technology and surging imports of tires. Dialogue has been the principal tool of past administrations to get China to change its actions, and those efforts have met with limited success.

The Administration has chosen to broadly challenge Chinese policies – with Section 232, Section 301, Section 201 and otherwise. It's clear that the business-as-usual approach of the past of dialogue and denial wasn't working – one can measure that by rising trade deficits, shuttered facilities and lost jobs. Now that serious engagement has started, it is not the time to let up: We need to see this through, although there certainly could be some pain along the way, if we are to address the competitive threats our nation faces.

4. **To what degree have the U.S. government and American companies sought remedies in international/multilateral fora? What have been the results? How can we more effectively take advantage of these venues to protect American economic competitiveness? From a U.S. perspective, are key international/multilateral organizations fulfilling their mandates? Do they need to be reformed to address current predatory economic practices and to reflect the characteristics of the modem, global economy? If so, how?**

As noted, the U.S. government has had a limited agenda in terms of seeking to address our trade challenges in international fora. Clearly, if bilateral or multilateral dialogue and engagement can address our problems, that would be the preferred course. But, over time, with China and other countries, that engagement has often proved fruitless.

Indeed, with regard to the WTO, challenges often take 2-5 years to resolve. Many challenges are lost as the WTO, through the appellate body, has imposed obligations that were never negotiated. This "overreach" has become a fundamental problem for the U.S. and is being challenged by the USTR. This has occurred in cases ranging from the ruling against the so-called "Byrd Amendment" to certain dumping methodologies.

And, relief under our trade laws and at the WTO is prospective in nature. By the time relief may be available, much of the injury has already occurred. Of course, the relief is important but a firm may never recover lost sales and workers may never recover their jobs or wages. Other countries know that they can often get away with their predatory practices for significant periods of time.

In addition, while our trade laws have been updated somewhat by Congress in the past several years, with important changes, more must be done. For example, the potential for foreign state-owned and invested enterprises to increase their operations here – through acquisitions or greenfield investments – poses a serious threat to the operation of our trade laws and for market-based firms to compete. Take, for example, the case of Tainjin Pipe, a Chinese state-owned firm setting up operations in Texas. The U.S. pipe market is already in trouble with operations shutdown, idled or operating at reduce capacity. Tainjin will have access to low-, or no-cost capital that directly challenges the operating margins of our firms. Tainjin may import so-called "green pipe" to avoid existing antidumping and countervailing duty orders and undergo minor finishing operations resulting in further cost advantages which can't be met by our firms. And, to top it off, under our trade laws, Tainjin will have standing to try and undermine potential trade cases opposing them from even proceeding as they would qualify as a domestic producer.

Our trade laws need to be more actively used by our administration to pursue relief. Self-initiation authority exists, but has only been used once by this Administration. The burden should not be on private companies and workers to fight for trade enforcement – it should be an automatic right. We also need to examine, as the USTR has been doing, how to reform the WTO and need to look at whether other avenues for relief exist. We need to engage our trading partners to develop coalition efforts. And, we must not be reluctant to directly challenge our trading partners – China and others – when they break the rules and threaten our future.

5. **Besides the U.S., what other countries are most negatively impacted by China's predatory international economic and business practices? Do these countries represent natural allies for the U.S. in an effort to put an optimal multilateral pressure on China to reform its practices?**

It's not hyperbole to say that the entire world economy has been impacted by China's predatory international economic and business practices. From the U.S. to Latin America to Africa to Europe and other portions of the globe, China's policies have had an impact. China's thirst for resources has changed world markets as it has taken steps to secure resources to support its economy and its interests. It has invested billions of dollars in nations across the globe to ensure that it has the energy and mineral resources it needs. Many of these investments have skewed markets, empowered regimes and changed economies.

Often this investment is welcomed as the U.S. has substituted trade for aid, and that trade often comes with "strings" including anti-development requirements, financial deregulations and requirements that increase the price of medicines for needy people.

China's continued development of its industrial capacity has resulted in massive productive capacity, often significant <u>overcapacity</u> that threatens market-oriented producers here in the U.S. and around the globe. While much attention has been given to China's steel and aluminum overcapacity, it extends to many more sectors including shipbuilding, rubber, glass, chemicals and others.

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Suffice it to say that China's activities effect virtually every country's economy.

That provides an opportunity for coalition-building to address China's policies and practices. For some cases, such as the current challenge to China's intellectual property violations, the EU, Japan and other countries have either indicated support, or are likely to support us. On overcapacity, there are ongoing talks at the OECD and at the Global Forum on Steel spurred by action by the G-20.

At the same time, China has influence operations – direct and indirect – targeted at key trade allies who should be on our side. From contracts to investments to political support, to other activities, China seeks to ensure that it can continue its practices without interference from the world community.

Much more can be done, but we also have to recognize that, with regard to some multilateral fora, such as the World Trade Organization, they have not been up to the task. While formal complaints can be adjudicated, although it may be 2-5 years before final relief is available, the organizations can be disabled by consensus-oriented rules. And, China is very good at utilizing its vast power to delay, deter and deny action to address its activities.

China also often refuses to acknowledge its illegal actions when confronted directly. The decision by the UN Convention on the Law of the Sea (UNCLOS) in the case filed by the Philippines against China's activities in the South China Sea was ignored by China. And, to date, there have been no real repercussions to China's actions as it has continued to reclaim rocks and reefs and militarize them. Many believe that the U.S. has limited ability to engage on the specifics of the case as it is not a signatory to the Convention.

The current tension in the global economy may provide an opportunity to address China's activities. The U.S. has led the effort. But, it's time for other countries to stop holding our coat while we bloody our nose. International engagement and support for our efforts to address China's predatory and protectionist policies can help resolve these matters and ensure that market-oriented approaches guide the results. That is the preferred course, but we cannot wait for others to join in. Negotiations have been launched and pushing our chairs away from the negotiating table while we wait for multilateral engagement will only embolden China to continue on its present path.

6. **What are the current U.S. legal, regulatory, and other tools to protect U.S. interests in cases where there is an identified threat? How can the U.S. better use those tools? What additional tools are needed?**

The U.S. has a broad array of existing tools to address U.S. economic interests. As has been noted, one of the problems is that Administration has largely left enforcement and action on these issues to the private sector. Indeed, while President George W. Bush initiated action under Section 201 on steel early in his Administration, that was only after it was clear that the Senate Finance Committee was poised to act, under its authority to seek action.

The current Administration has shown a willingness to use a variety of tools to act, including Section 301 (to address violations of trade agreements and unjustified, unreasonable or discriminatory acts), Title VII authority (antidumping and countervailing duty authority), Section 232 (to address imports that threaten national security), International Emergency Economic Powers Act (IEEPA), the Committee on Foreign Investment in the United States (CFIUS), and other authorities.

My view is that we have many of the tools, we just have not either been willing to use them, or need to be more creative in assessing their utility. For example, Section 482 of the Internal Revenue Code allows for action against transfer pricing schemes. This authority was used as a tool when Japan was alleged to have engaged in transfer pricing abuses in the past to diminish the stated profits of their subsidiaries here in the U.S. As foreign firms expand their operations and investments in the U.S., we need to make sure that they are not using transfer pricing as a means to essentially subsidize their operations.

The Securities and Exchange Commission has broad authority to assess the operations of entities listed on U.S. exchanges to determine whether there are "material" events that investors should be aware of. A number of Chinese state-owned firms are listed on the New York Stock Exchange and many other Chinese firms are listed elsewhere. China's desire to access U.S. capital markets is clear, especially noted by their recent failed attempt to acquire the Chicago Stock Exchange. The SEC can evaluate these companies to ensure that U.S. investor interests are not being put at risk.

The SEC, in cooperation with law enforcement and intelligence authorities, should also assist in evaluating potential acquisitions of U.S. companies to determine whether there have been efforts to undermine the market value of the acquisition targets. This is an area of extreme importance.

Similarly, as the China Commission recommended last year, "Congress should consider legislation to ban and delist companies seeking to list on U.S. stock exchanges that are based in countries that have not signed a reciprocity agreement with the Public Company Accounting Oversight Board (PCAOB)." The inability of our auditors to have full and unfettered access to the work papers associated with the financial operations of companies listed on our exchanges puts at risk the integrity of the information provided to investors.

The Department of Commerce has extensive authority to collect information on the activities and operations of firms operating in the U.S. market. For the China Commission, we have been trying to learn about how Chinese firms operating here operate similarly, or differently, from their U.S counterparts. We have been unable to identify comprehensive business school type case studies that would help shed light on these operations. The DOC's existing authority to issue questionnaires and collect data could help advance our understanding of the operations of foreign firms in our market and determine whether any actions might be appropriate to address problems, if they exist.

I believe that there should first be an assessment of existing authorities, their utility and the willingness of authorities to utilize them before we have an expansive examination of what additional tools are needed. In my view, the failure of government to act has created a climate that essentially tells our trading partners they can engage in predatory acts with virtual impunity. That must change.

But, there are three quick suggestions I will make that will be further discussed as a response to the last question posed by the Subcommittee.

First, Congress should consider S. 2757, the National Economic Security Strategy Act of 2018.

Second, the underlying authority for the Committee on Foreign Investment in the United States must be updated to address new challenges and threats.

Third, we should act on S. 2566, the Level Playing Field in Global Trade Act of 2018 to ensure that trade agreements include enforceable standards to promote living wages and sustainable production methods.

7. **What is your assessment of S. 2757, the *National Economic Security Strategy Act of 2018*? Do you support this legislation? Why do you believe it is necessary?**

I want to commend the Chair and Ranking Member, along with Senators Rubio and Coons for coauthoring and introducing this legislation. I believe it should be a priority for this Congress to consider how to address the important issues raised by this bill, in particular, the development of a national economic security strategy.

Last year, the China Commission assessed China's activities in the high technology sector. In assessing China's activities, and U.S. policies, the Commission recommended that

> Congress direct the National Science and Technology Council, in coordination with the National Economic Council and relevant agencies, to identify gaps in U.S. technological development vis- à-vis China, including funding, science, technology, engineering, and mathematics workforce development, interagency coordination, and utilization of existing innovation and manufacturing institutes, and, following this assessment, develop and update biennially a comprehensive strategic plan to enhance U.S. competitiveness in advanced science and technology.

S. 2757 takes a more expansive, and appropriate view, of the need for a broader national economic security strategy that looks beyond the high technology sector to U.S. interests at large. It requires the periodic preparation, and publication of a national economic security strategy for the U.S. That approach will fill a critical gap in public policy and enable an all-of-government and public understanding of the challenges facing our nation, and the action plan to address those challenges.

In the 1980s, America faced similar questions about its competitiveness. While the impact of Japans' economic policies pale in comparison to those posed by China and other countries today,

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the concerns nevertheless generated enormous debate. Policy, labor, corporate and academic leaders opined about what the state of America's economy was, what our future had in store for us and what actions might be appropriate to take.

A pivotal event during that period was the convening of the President's Commission on Industrial Competitiveness, chaired by John Young, who was then the President and CEO of Hewlett-Packard. The report of the Young Commission, and subsequent public debate, triggered action by government and the private sector. It also helped foster the development of the Omnibus Trade Act of 1988 which was a comprehensive approach to address many of the challenges that existed at the time and expanded trade law provisions to respond to predatory acts, increased support for the research and development and expanded the role of the National Institutes for Standards and Technology, enhanced the authorization for the Committee on Foreign Investment in the United States (CFIUS), and authorized a number of other important programs and initiatives.

I spend an enormous amount of time with labor leaders, workers and domestic corporations to try and identify ways to promote production and employment in the U.S. Unfortunately, there is no well-defined strategy that gives confidence that the challenges facing our nation are understood, and that there is an action plan to address those challenges. Your legislation, much like the National Security Strategy that focuses on our military security challenges, will help ensure that there is a coordinated, comprehensive and clear plan to enhance our nation's competitiveness and, in turn, our economic and national security. That is a vital step forward.

As part of the assessment, the critical question of income inequality and measures to address it should be included. The International Monetary Fund and others have recognized the impact of inequality on the economy.

It is also critical that an action plan puts the nation's and not a political party's interests first. The balanced, bipartisan authorship of the legislation is a strong indicator that a national economic strategy can be developed that can address today's challenges and prepare our country for the future.

8. **Please provide specific policy/legislative recommendations to improve American economic competitiveness and security.**

In my testimony, I have identified several areas that demand attention and action. Let me reiterate some of those here, and elaborate, where appropriate.

As noted, the authorship by several members of this Subcommittee of S.2757, the National Economic Security Strategy Act of 2018 signifies an important bipartisan opportunity to provide an assessment of our nation's competitiveness and our security challenges and provide for the publication of an action plan to address those issues. A comprehensive approach to these challenges is solely needed.

Congress should also act to update the authority for the Committee on Foreign Investment in the United States. The AFL-CIO recently endorsed the bipartisan Foreign Investment Risk Review Modernization Act (FIIRMA) that is before the House and Senate. It is a reasoned

approach that balances the desire to continue our open investment climate and our security interests. The AFL noted that the scope of the legislation should not be diminished but, rather, Congress should consider the inclusion of a net-economic benefit test as countries such as Canada and Australia have in their investment screening regimes.

Congress should act on S 2566, the Level Playing Field in Global Trade Act of 2018, introduced by Senator Merkley. This legislation would ensure that trade agreements include enforceable standards to promote living wages and ensure sustainable production methods. Many other countries use low wages and lax environmental standards as an incentive to outsource production and offshore jobs to those areas. We must not allow attacks on workers or the environment to continue to undermine our own living standard and environmental regime. New trade agreements can be a force for progress if they are correctly constructed and properly enforced.

As the China Commission recommended in its 2016 Annual Report, Congress should "enact legislation requiring its approval before China – either the country as a whole or individual sectors or entities – is granted status as a market economy by the United States. This is a critical issue and has been a high priority for the Chinese leadership, having been raised, once again, in the bilateral talks with the U.S. last week. China is far from being a market economy, but the Department of Commerce has the unilateral authority to change its current designation. There is no sign that Commerce has any intent of changing the designation, but Congress should affirm that it is the view of Congress that no action can occur on this substantive matter in the future without its consent.

In an additional recommendation made by the China Commission in 2016, Congress should "require that under antidumping and countervailing duty laws, Chinese state-owned and state-controlled enterprises are presumed to be operating on behalf of the state and, as a result, do not have standing under U.S. trade laws against unfair trade to block a case before proceeding.

A critical issue that is vital to ensuring a competitive economy is expanding investments in infrastructure. In addition to expanding the capacity for economic growth, infrastructure investments can expand our ability to bring products to market, equip our citizens with access to high-speed internet, enhance educational opportunities and meet other critical needs.

The above are just some of the many actions that Congress should consider as it evaluates this important subject area. I would welcome the opportunity to work with you and your staffs as your work continues.

Again, thank you for the invitation to appear before you today and I look forward to your questions.

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Press Releases

House Passes Foreign Investment Reform Bill

Washington, June 26, 2018 -

The House of Representatives today passed the Foreign Investment Risk Review Modernization Act of 2018 (FIRRMA) by a strong bipartisan vote of 400-2.

"This bill is a comprehensive reform of the Committee on Foreign Investment in the United States (CFIUS) - the first update of its kind in over a decade. CFIUS is authorized to review foreign investment transactions that may threaten our national security, and although these authorities have been wielded carefully, Congress must remain vigilant when delegating additional powers that may have far-reaching effects," said Financial Services Committee Chairman Jeb Hensarling (R-TX) during today's debate on the House Floor. "We target those transactions and countries – including China – that truly present a national security risk, but without giving bureaucrats free rein to strangle the investment and innovation that makes our country strong to begin with."

H.R. 5841, the Foreign Investment Risk Review Modernization Act of 2018 (FIRRMA), sponsored by Representative Robert Pittenger (R-NC), would provide a comprehensive update to both the Committee on Foreign Investment in the United States (CFIUS) and the export control regime. CFIUS, a cross-agency panel that screens proposed foreign investments for national security risks, has not been updated since 2007 and requires

"Our committee is fighting for economic opportunity so hardworking taxpayers can achieve financial independence."

CHAIRMAN JEB HENSARLING

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U.S. National Debt

As of July 23, 2018 our National Debt is:

$21,272,546,647,599

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modernization to keep pace with the growing number and complexity of foreign investment deals. At the same time, H.R. 5841 makes clear that the U.S. must maintain its enthusiastic support for foreign investment, which is crucial for U.S. jobs, innovation, and productivity.

H.R. 5841 addresses potential national security threats, particularly those emanating from China, by closing loopholes in CFIUS's jurisdiction. The bill also clarifies terms involving critical technologies and infrastructure to give U.S. businesses and foreign investors legal and regulatory certainty.

"For over two years, we have fought for CFIUS reform and the implementation of stronger policies to combat strategic and disruptive Chinese activities. Today, I am grateful that the House is taking action on this issue. This landmark legislation will take enormous steps to improve our foreign investment review process to prevent further transfers of military applicable technologies to the Chinese government," said Pittenger.

"In 2016, new foreign direct investment added $894 billion in value to the U.S. economy. But with a surge of malign investment by the Chinese in U.S. assets resulting in the theft of American intellectual property and the transfer of critical technology, it is vital that Congress modernize both the Committee on Foreign Investment in the United States and our export controls. We can do this by closing loopholes and preventing adversaries from obtaining access to sensitive personal data and critical technology or gaining influence over the management or operations of critical infrastructure in the United States. At the same time, preserving an open investment climate is critical to American competitiveness and economic strength, which is itself a component of American national security. I am proud of the Committee's work to implement these needed, nonpartisan reforms and I want to especially thank Chairman Hensarling, Representative Pittenger, and House Leadership for their important work to bolster both economic growth and strong national security," said Representative Andy Barr (R-KY), Chairman of the Subcommittee on Monetary Policy and Trade.

The Financial Services Committee favorably reported this bill to the House in May 2018 by a unanimous vote of 53-0.

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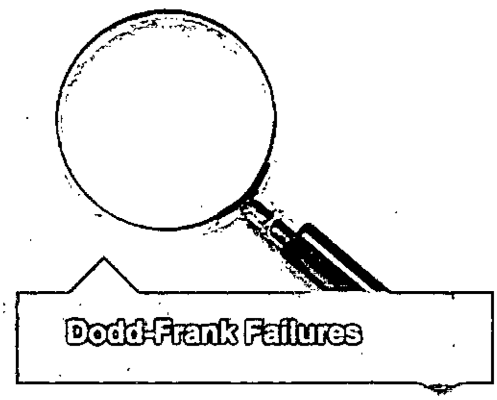
Issues



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S.2098 - Foreign Investment Risk Review Modernization Act of 2018

115th Congress (2017-2018) | Get alerts

Sponsor: Sen. Cornyn, John [R-TX] (Introduced 11/08/2017)

Committees: Senate - Banking, Housing, and Urban Affairs

Latest Action: Senate - 05/22/2018 Placed on Senate Legislative Calendar under General Orders. Calendar No. 426. (All Actions)

Tracker: **Introduced** Passed Senate Passed House To President Became Law

All Actions S.2098 — 115th Congress (2017-2018)

All Information (Except Text)

Bill History – Congressional Record References

7 results for All Actions | Compact View

Newest to Oldest ▼

Date	All Actions
05/22/2018	Placed on Senate Legislative Calendar under General Orders. Calendar No. 426. Action By: Senate
05/22/2018	Committee on Banking, Housing, and Urban Affairs. Reported by Senator Crapo with an amendment in the nature of a substitute and an amendment to the title. Without written report. Action By: Committee on Banking, Housing, and Urban Affairs

Date	All Actions
05/22/2018	Committee on Banking, Housing, and Urban Affairs. Ordered to be reported with an amendment in the nature of a substitute favorably. Action By: Committee on Banking, Housing, and Urban Affairs
01/30/2018	Committee on Banking, Housing, and Urban Affairs. Hearings held. Action By: Committee on Banking, Housing, and Urban Affairs
01/25/2018	Committee on Banking, Housing, and Urban Affairs. Hearings held. Hearings printed: S.Hrg. 115-160. Action By: Committee on Banking, Housing, and Urban Affairs
01/18/2018	Committee on Banking, Housing, and Urban Affairs. Hearings held. Action By: Committee on Banking, Housing, and Urban Affairs
11/08/2017	Read twice and referred to the Committee on Banking, Housing, and Urban Affairs. (text of measure as introduced: CR S7111-7

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US-China foreign investment f percent in 2017: report

BY SYLVAN LANE - 04/10/18 04:50 PM EDT

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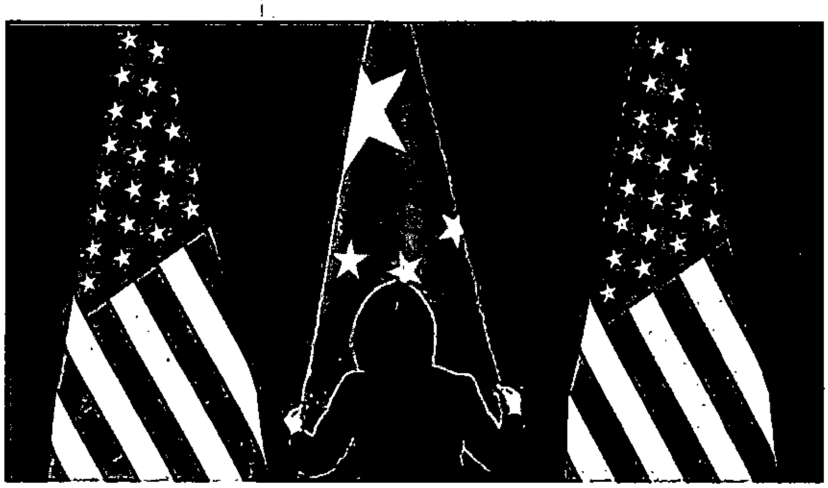

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Foreign direct investment between the U.S. and China fell by 28 percent in 2017, according to a report released Tuesday, amid growing economic tensions between the two countries.

Private sector investments between the U.S. and China totaled $43.4 billion in 2017, according the National Committee on U.S.-China relations, an American nonprofit supporting closer economic ties between the countries.

Cross-border investments between the countries dropped 28 percent from $60 billion in 2016, according to the report.

The nonprofit attributed the steep drop to an $17 billion decrease in Chinese investments in U.S. businesses. They fell from $46 billion in 2016 to $29 billion last year. U.S. investments in China totaled $14 billion in 2017, relatively unchanged from $13.8 billion in 2016.

Economic ties between the U.S. and China have soured since President Trump took office with the promise of cracking down on Beijing's efforts to undercut American manufacturing. Trump has since approved roughly $50 billion in tariffs on China, sparking a potential trade war between the countries.

The report attributes the 2017 decline to Beijing tightening controls over investments abroad, delaying efforts to open its capital markets to

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foreigners and a series of Chinese acquisitions of U.S. companies blocked by the Treasury Department.

"China's commitment to deepening economic reforms and market access for foreign firms remains an open question at this juncture," the report reads. "This ambiguity and the limited space for open discussion about China's reform direction present challenges for sustaining and further expanding foreign investment flows."

The report also cited how the Trump administration "is redefining the US-China relationship by declaring China a 'rival power' and taking a more confrontative approach to trade and investment relations."

The Trump administration has flexed its power to block Chinese acquisitions of U.S. tech firms through the Committee on Foreign Investment in the U.S. (CFIUS), a Treasury Department agency that vets such business deals for potential national security threats.

CFIUS has blocked several high profile deals over concerns that the Chinese government would obtain access to information and intellectual property that could undermine U.S. national security.

CFIUS blocked the sale of Lattice, an Oregon-based semiconductor and chip manufacturer, to a group of investors that included Chinese state-owned entities. The panel also killed the sale of MoneyGram, a money transfer firm, to a subsidiary of the Chinese company Alibaba.

The report estimates that more than $8 billion worth of deals were abandoned in 2017 due to "unresolvable CFIUS concerns."

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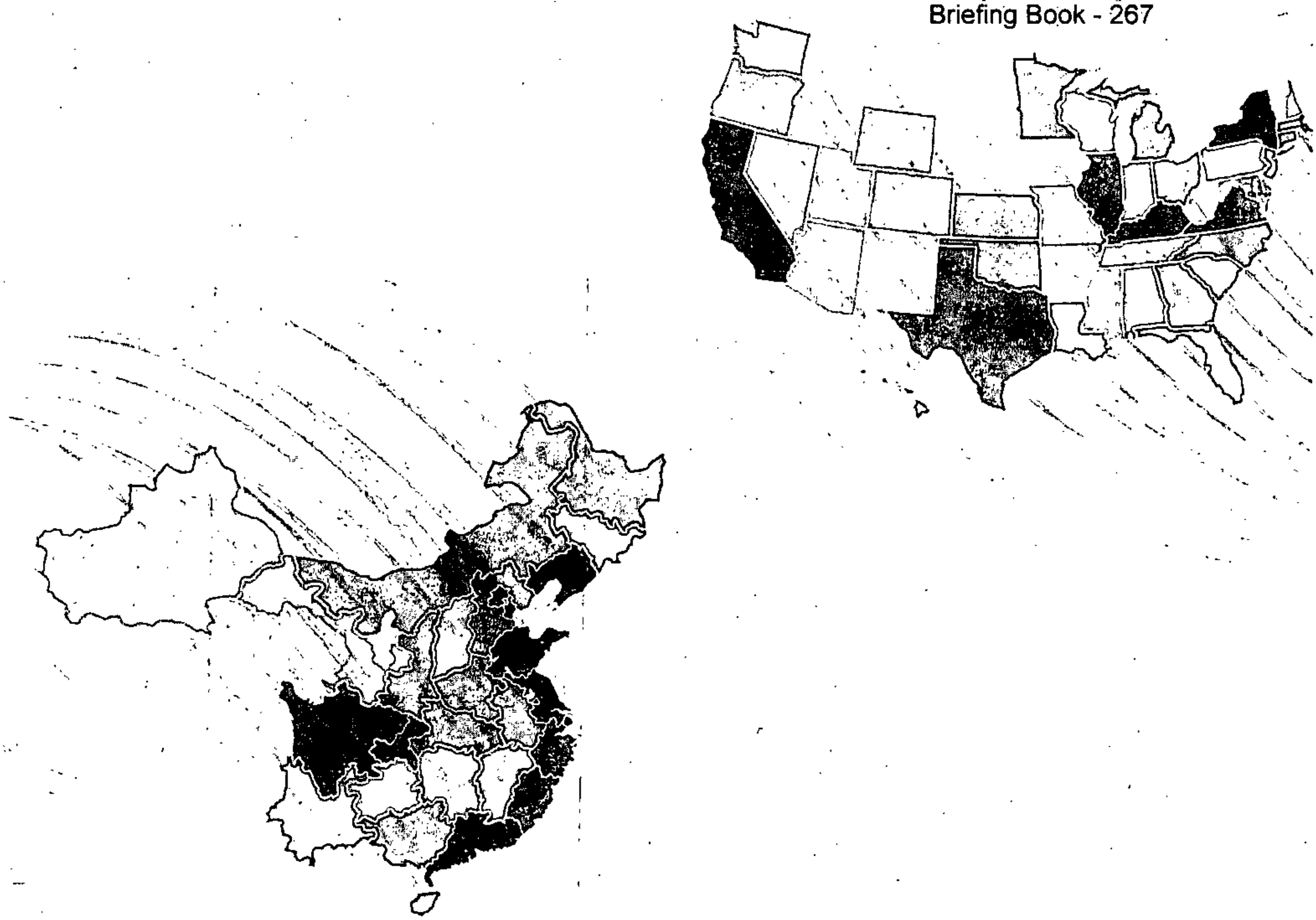

Two-Way Street: 2018 Update
US-China Direct Investment Trends

Thilo Hanemann, Daniel H. Rosen and Cassie Gao

APRIL 2018

A report by

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EXECUTIVE SUMMARY

The US-China FDI Project clarifies trends and patterns in foreign direct investment (FDI) flows between the world's two largest economies. This report updates the picture with full year 2017 data and describes the outlook for 2018. The key findings are:

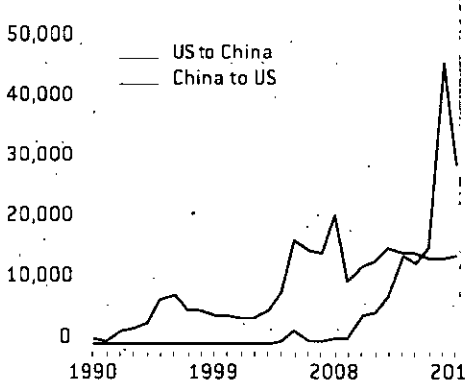
(1) Two-way US-China FDI declined by almost one-third in 2017 compared to 2016, due to a drop in Chinese investment in the US.

- Consummated 2017 FDI transactions between China and the US reached $43.4 billion. This represents a 28% drop from the $60 billion we recorded for 2016, but is still the second highest year on record.
- The reason for this drop was a decline in Chinese investment in the US to $29 billion in 2017 from $46 billion in 2016. This decline would have been much steeper without the $18 billion of Chinese acquisitions that were announced in 2016 but completed in 2017. American investment into China was almost unchanged over the previous year, at $14 billion (compared to $13.8 billion in 2016).
- Flows remained unbalanced with Chinese FDI in the US at twice the level of US investment in China ($29 billion vs. $14 billion). In terms of stock, US companies still have significantly more historical investment in China ($256 billion) than their Chinese counterparts have in the US ($140 billion).

2) Policy and politics in China and the US – rather than commercial forces – are mostly to blame for the two-way investment decline.

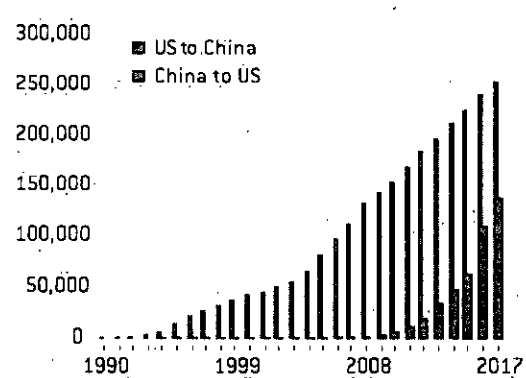
- Chinese investment in the US was curtailed by Beijing tightening controls over outbound investment and a crackdown on leveraged private investors, which caused China's global outbound FDI (OFDI) to decline for the first time in more than a decade.
- Chinese acquisitions in the United States were also pruned by increased investment screening by the Committee on Foreign Investment in the United States (CFIUS), a result of both changing threat assessments and a longer than usual leadership vacuum during the transition to a new administration. We estimate that deals worth more than $8 billion were abandoned in 2017 due to unresolvable CFIUS concerns.
- US FDI to China remained largely flat in 2017 as

Figure ES-1: Annual Value of FDI Transactions between the US and China, 1990-2017
USD million



Source: Rhodium Group.

Figure ES-2: Cumulative Value of FDI Transactions between the US and China, 1990-2017
USD million



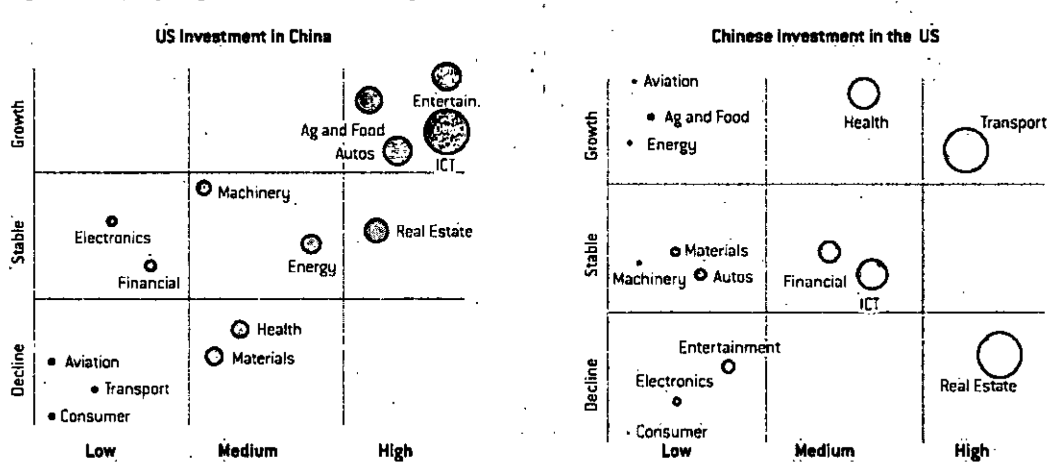
Source: Rhodium Group.

Beijing delayed market reforms and meaningful liberalization of market access for foreign investors. Investment momentum was strong in unpenetrated consumer-related industries (such as entertainment parks) and sectors promoted by industrial and localization policies (such as electric vehicles, semiconductors and information and telecommunications (ICT) services).

(3) Policy interventions impacted the industry composition of investment, in both directions.

- The 2017 industry mix for Chinese FDI in the US was impacted by deals carried over from 2016, but deal-making in the second half of the year showed a clear shift toward sectors supported by policy. The big losers from China's new outbound investment rules were entertainment, real estate and hospitality, and consumer products and services. Investment remained stable or grew in many high-tech sectors (health and biotech, ICT) and industries related to China's global infrastructure push (transport and infrastructure).
- While endorsed by Beijing, Chinese acquisitions in high-tech sectors were increasingly scrutinized by CFIUS, especially in areas seen as relevant to current defense capabilities (semiconductors) or future defense applications ("emerging critical technologies"). The safety and integrity of personal data of US citizens has also taken a greater role in CFIUS assessments of Chinese acquisitions.
- China made some progress on improving investment market access for foreign investors in 2017, but these changes were not substantial enough to materially impact foreign investment patterns. US companies and other foreign investors remain focused on existing consumer-related opportunities (food and theme parks). Investment appears to be increasingly driven by industrial policy (such as the push for electric vehicles, the desire to nurture a domestic semiconductor industry and localization requirements for ICT firms).

FIG ES-3: Two-Way FDI between China and the US by Industry, 2017
Stylized display of growth momentum (y axis) and investment value in 2017 (x axis, bubble size)



Source: Rhodium Group.

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(4) Policy developments are reshaping the investor mix in both directions.

- New outbound restrictions reduced overseas activities by large, heavily leveraged private Chinese conglomerates that had been major drivers of Chinese investment in the US over the past three years. While these players retreated in 2017, small- and medium-sized investments by real economy firms remained resilient. Private equity funds and other established financial investors were less impacted by capital controls, especially those with offshore funds. Sovereign and certain state-owned players have also proved better able to navigate the new regulatory environment, though their investments in the US remain small.
- For US FDI in China, private equity firms and other financial players remain important, but they continue to focus on small- and medium-sized transactions. The big-ticket investments in 2017 were all made by major multinationals in the automotive, ICT and consumer sectors, often driven by industrial policies (semiconductors) or localization requirements (cloud computing).

(5) Venture capital and other non-FDI investment grew rapidly in recent years but also slowed in 2017.

- Direct investment has traditionally dominated two-way US-China flows, but other types of investment – and particularly venture capital (VC) – are becoming important.
- US firms were early investors in many Chinese startups and have participated in more than 1,500 funding rounds over the past 15 years. However, activity peaked in 2015 and has slowed since, partially because Chinese firms became a more viable alternative. One interesting trend in 2017 was that American and other foreign private equity firms geared up to invest in Chinese distressed assets.
- Chinese venture capital was barely existent in the US just a few years ago but has swelled rapidly in Silicon Valley and other US technology clusters in the past three years. This activity also slowed in 2017, but not nearly as sharply as FDI flows.

(6) The outlook for two-way investment is fragile as Washington and Beijing re-assess the foundations of the economic and political relationship.

- China is signaling it will take a more relaxed view on outbound investment as capital outflow concerns have subsided. However, temporary restrictions were formalized into new OFDI rules permitting intervention in transactions at any time, a step backwards from 2014 liberalization.
- On the inbound side, China's commitment to further market reforms is less certain than it was in the years after the 2013 Third Plenum initiative was announced, leaving potential foreign investors with doubts about Beijing's seriousness about leveling the playing field for non-native businesses.
- In the US, Congress plans to overhaul the US investment screening regime, the White House plans action against Chinese FDI as part of its Section 301 case on Chinese intellectual property threats, and traditional advocates of moderation including the business community are less willing to push back. While there is room for continued two-way investment growth even with heightened security screening, risks of strategic conflict are threatening that growth prospect.

(7) There is still room for two-way investment flows in non-sensitive areas if current concerns are managed properly.

- In the US, the extent of strategic re-orientation will make a huge difference for future two-way flows. If it were just a matter of narrowly defined national security, the US could redouble its diligence screening for risks and still enjoy a great expansion of Chinese investment: today's levels

are not high in proportion to the size of our two economies. But a draconian effort to push back on China's economic footprint in America in ways that transcends discreet national security concerns will forfeit these opportunities.

- China's preference for convergence or divergence with advanced economy norms is the other essential determinant of future US-China two-way investment potential. Economic interaction – in FDI, trade and other areas – is dependent on like-mindedness about the future. In 2017 Beijing stressed the non-convergent aspects of its policy plans, triggering new debate about the prospects for investment under different assumptions. Past FDI volumes, and even existing deals, cannot be taken for granted in either direction if convergence is off the table.

(8) The US-China investment relationship will be an important determinant for how other countries handle investment relations with China.

- While many of the Trump administration's threats to be tougher on China are loathsome to US allies, many of the direct investment considerations under review in the US are in line with consideration of other advanced economies.
- As other advanced economies look at their bilateral investment relationships with China through the same lens as Washington, it is possible that shared approaches to managing security concerns will emerge. Ultimately, a multilateral framework for managing concerns about cross border direct investment is likely to be the most effective approach.

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Statement Before the
House Committee on Financial Services,
Subcommittee on Monetary Policy and Trade

"Evaluating CFIUS: Challenges Posed by a Changing Global Economy"

A Testimony by:

Scott Kennedy

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Director, Project on Chinese Business and Political Economy
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January 9, 2018

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Introduction and Main Points

Thank you for the invitation to appear before the committee. I have been asked to share my views about Chinese industrial policy, trends in technology flows, and the implications for American policy to limit diffusion of advanced technologies to China that could harm U.S. national security, including the role of CFIUS.

I. Summary

I want to make four points today.

First, although highly wasteful and inefficient, Chinese industrial policy has been relatively effective at facilitating both the domestic development of technology in China as well as the acquisition of foreign technology from the United States and elsewhere. All signs point to China further strengthening its industrial policy apparatus and not engaging in substantial marketization and liberalization in the coming years.

Second, although the US-China relationship has many problematic elements, economic ties on balance have and continue to benefit the American economy, including companies, workers, and consumers. At the same time, the US and China have conflicting security interests in the Asia-Pacific, creating the difficult situation in which the economic and security components of the relationship are to some extent contradictory. I expect this tension will also persist well in to the future.

Third, American technology reaches China through a wide variety of channels, including investment, trade, employment, and education. Constraining technology diffusion in one area does not stop its diffusion via other means.

And fourth, American policies taking these three factors into account would require the US to: 1) Focus on technology that could harm American national security that China does not already have and would have difficulty developing domestically; 2) Take into account that technology diffusion occurs via multiple routes, and that some routes are easier to regulate than others; 3) To be successful, the United States needs to expand coordination of its technology control policies with those of its allies; and 4) Adopt policies that are highly targeted so that they do not hurt the vibrancy of the American economy.

My written and oral testimony seek to elaborate on these four points.

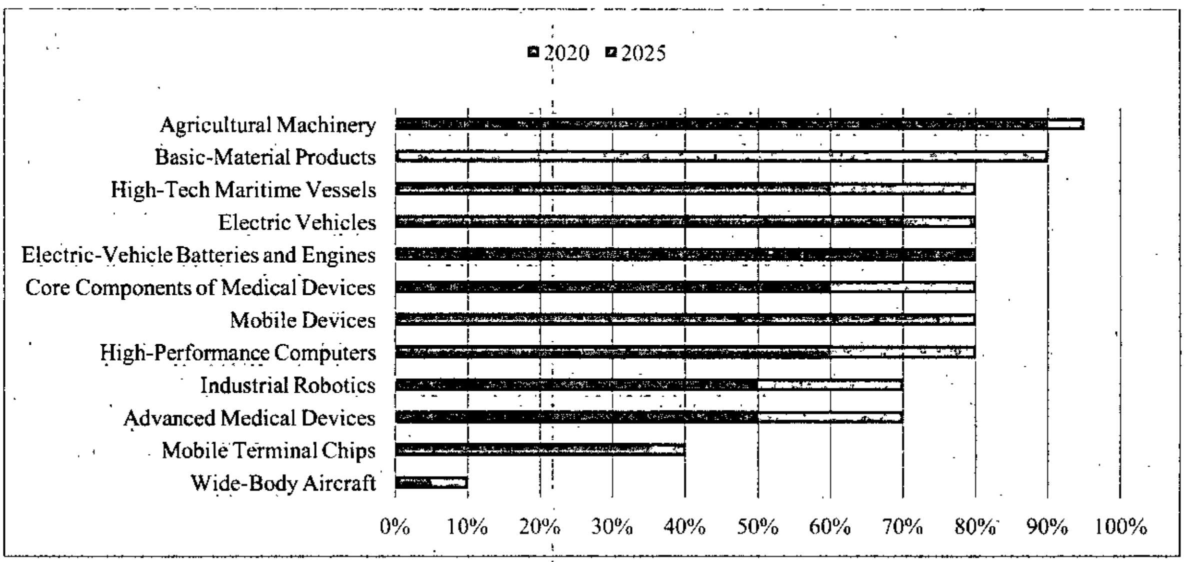
I. The State of Chinese Industrial Policy

2018 marks the 40th anniversary of China's launching of the Era of Reform and Opening Up. Compared to the autarkic state socialist system in which the country found itself at the end of the Cultural Revolution, four decades later China's economy is far more marketized and open. Private firms account for the large majority of the country's employment, profitability, and economic growth. The vast majority of prices for final goods and services are set by the market, and the financial system is large and diverse. China's average tariffs have fallen from 14.1% in

2001 to 4.2% in 2016, the country is the largest recipient of foreign direct investment (with over 520,000 foreign-invested firms in China), and China is the fastest growing source of outward direct and portfolio investment.

That said, the Chinese state is far from a neutral referee of a competitive marketplace. Rather, its consistent goal has been to use state authority to not only further the overall growth of the economy but to promote specific companies, sectors, and regions. Although China's leadership in the late 1990s and early 2000s made a genuine effort to marketize the economy and sought WTO entry to pursue that goal, their successors have not maintained the same commitment. Under the leadership of Hu Jintao and Wen Jiabao (2002-2012), China reinvigorated the industrial policy apparatus and ramped up state-directed investment in priority sectors and projects. Under their watch China set forth the goal of "indigenous innovation," which still holds today, of making industrial policy's chief aim the development and acquisition of more advanced technology by domestic actors in order to raise productivity and make China more competitive internationally.

Figure 1: Selected Domestic Market Share Targets of *Made in China 2025*



Source: China Ministry of Industry and Information Technology.
Note: The government set targets for 2020 and 2025 for most technologies, but not all. Hence, some denote only a single target.

Since Xi Jinping assumed power in late 2012, several trends have emerged. First, China has only intensified its industrial policy efforts. China's goals are far more ambitious than in the past, as it aims to have Chinese firms become dominant in just about every area of advanced technology imaginable. The 13th Five-Year Plan calls for a rapid growth in R&D spending, the number of patents, and the contribution of science & technology to the economy, and identifies over 200 technologies deserving support. *Made in China 2025*, a strategy document issued in 2015 and a high-priority component of the 13th Five-Year Plan, sets forth high targets for the local firms'

market share in China of technologies and supply chains by 2025, such as 80% for electric vehicles, 70% for industrial robotics, and 70% for advanced medical devices (see Figure 1).[1]

Second, the scale of Chinese initiatives and investment has grown enormously, with spending on research and development (R&D) in 2016 reaching over $232 billion. Direct government funding is growing, but more important is how the state increasingly utilizes policy levers to induce banks, other financial institutions, companies and research institutes to target their own spending in priority sectors established by policymakers.[2]

Third, industrial policy is far more strategically coordinated than ever before. Local experimentation has declined in favor of centralization. The top leadership is more than ever utilizing "leading small groups" overseen by the Party and State Council (China's cabinet) leadership to reduce inter-bureaucratic conflicts and raise the likelihood that investments address the country's technology gaps. Relatedly, under Xi there is greater emphasis on coordinating the development of dual-use technologies, so that products and services created in a commercial environment are available for adoption by China's military, domestic security, and intelligence organizations.[3] During the implementation process, the various tools of industrial policy are increasingly coordinated with each other. Priority sectors and companies are supported through fiscal stimulus, tax reductions and holidays, access to low-cost or free land, low-interest credit, easier access to securities markets, patent approvals, discriminatory technical standards, antitrust policy directed against disfavored competitors, privileged government procurement, limits on market access, and other preferential policies.

And fourth, China has expanded efforts to have globalization serve the country's industrial policy goals. In addition to sending millions of students abroad over the last few decades to obtain advanced degrees in engineering and science, Chinese financial institutions and companies have ramped up outward investment and acquisition of overseas companies. According to the Rhodium Group, Chinese investment in the United States was at least $46 billion in 2016 and $26.4 billion in the first three quarters of 2017. The leading sectors of Chinese US investment in Q3 were in health and biotech, financial and business services, basic materials, and other high-tech. Looking globally in 2017, the overall level of outward investment declined somewhat as a result of China's fears about capital flight and corruption, but among deals being made recently, a higher proportion involve Chinese state-owned companies and

[1] Jost Wubbeke et al., *Made in China 2025: The Making of a High-Tech Superpower and Consequences for Industrial Countries* (Berlin: Mercator Institute for China Studies, December 2016); *China Manufacturing 2025: Putting Industrial Policy Ahead of Market Forces* (Beijing: European Union Chamber of Commerce in China, March 2017); and *Made in China 2025: Global Ambitions Built on Local Protections* (Washington, DC: U.S. Chamber of Commerce, September 2016).

[2] Scott Kennedy, *The Fat Tech Dragon: Benchmarking China's Innovation Drive* (Washington, DC: Center for Strategic and International Studies, August 2017): 19.

[3] Xi Jinping personally heads the Central Commission on Civilian-Military Integration Development. Christopher K. Johnson, Scott Kennedy and Mingda Qiu, "Xi's Signature Governance Innovation: The Rise of Leading Small Groups," CSIS Commentary, October 17, 2017, https://www.csis.org/analysis/xis-signature-governance-innovation-rise-leading-small-groups.

financial institutions and are in materials and high-tech sectors (telecom, media, computing).[4] Finally, as part of this effort, Chinese companies have opened up R&D centers in Silicon Valley and other high-tech hubs, and are hiring talent from other companies and straight out of universities to help them strengthen their own innovation capacity.

Looking ahead, there is every indication that China plans to continue along the current path in which industrial policy is intensively used to serve economic and strategic goals. And that is because despite all the waste that is created through extensive government intervention, the broader record, at least from the leadership's point of view, is "good-enough" success. The economy has grown faster longer than any other economy in history, and Chinese companies are gradually moving up the value-added chain and claiming more market share in China and abroad. And although there is concern about protectionism by the United States, Europe and their advanced industrialized neighbors, China believes it can continue to use its large market as leverage to obtain technology and knowhow from others for the foreseeable future.

II. The Benefits and Challenges in the US-China Economic Relationship

The economic relationship with China has created both benefits and problems for the American economy. Industrial policy certainly puts American companies at a disadvantage in China and in third markets. And given China's size, to the extent that Chinese successes are the product of subsidies and other distortions, this could challenge the health of not only individual competitors, but supply chains and business models that operate in a competitive environment where the participants face hard budget constraints. That said, to date, the American economy has on balance benefited from our relationship with China. Trade in goods and services is over $600 billion per year and two-way investment has risen substantially, all of which not only creates profits for companies, but employment for millions of workers, and less expensive goods for consumers. The relationship would be more beneficial if China would reduce its discriminatory policies, but the best way to deal with this problem is to find ways to constrain Chinese industrial policy, not shutdown the economic relationship.

The operating logic of American security policy is different, which is to safeguard the United States as much as possible. Fairness and balance are not typical principles of this effort. Whereas there may be technology transfers that are entirely reasonable when seen through a commercial lens, they may be entirely unreasonable when viewed in the context of national security. The United States faces a conundrum because the US-China economic relationship is so large and China is moving up the value-added chain so quickly in ways that may be reasonable, even if not welcome from a market competition perspective, but far more worrisome from a national security perspective. Chinese efforts in semiconductors, quantum computing, artificial

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[4] See the Rhodium Group's "China Investment Monitor," http://rhg.com/interactive/china-investment-monitor; Daniel H. Rosen and Thilo Hanemann, "Trump Heads to China – Is Chinese Investment Still Headed Here?" Rhodium Group, November 3, 2017, http://rhg.com/notes/trump-heads-to-china-is-chinese-investment-still-headed-here; and Thilo Hanemann, Adam Lysenko and Cassie Gao, "Tectonic Shifts: Chinese Outbound M&A in 1H 2017," Rhodium Group, June 27, 2017, http://rhg.com/notes/tectonic-shifts-chinese-outbound-ma-in-1h-2017.

intelligence, advanced materials, biologics, energy storage, aeronautics and space, and other areas may be headaches for American companies, but they are much greater concern for those responsible for ensuring America's national security.

III. Technology Diffusion to China

Another important element of China's technology engagement with the world is that it occurs via many different avenues. The various pathways include:

1. Attracting foreign investment in China.
2. Chinese investment abroad, both greenfield and M&As, including minority stakes.
3. Imports.
4. Hiring foreigners to work in Chinese companies and research institutes.
5. Sending Chinese students abroad to study (which totaled 4.6 million between 1978 and 2016).[5]
6. Theft of foreign technology through cyber and other means.

Two consequences emerge from this fact. First, Chinese companies that desire acquiring technology have many routes to success. If the investment route is blocked, they can look to imports, poaching employees, hiring students, or other means. Similarly, if a technology exists in multiple countries but not in China, they can also benefit from differences in regulatory environments and levels of vigilance between jurisdictions.

And second, governmental authorities may benefit from deals and interactions that are entirely commercial or private. Not all of the elements of international technology acquisition are all part of a single, unified industrial policy. Much trade and investment is entirely private and does not involve approval by China's industrial policy apparatus or national security bureaucracy. This is particularly true for R&D centers – in both directions – as well as overseas students. That said, it is certainly possible that originally entirely private activity could be identified and utilized by China's authorities to serve China's domestic and national security goals.

[5] This data is from China's Ministry of Education, https://mp.weixin.qq.com/s/5764saZiSyFlnH6um46Jtg. According to the US-based Institute of International Education, in 2016, there were 328,500 Chinese students studying in the United States, of which 140,300 were in science and engineering programs: https://www.iie.org/Research-and-Insights/Open-Doors/Data/International-Students/Places-of-Origin, and https://www.iie.org/Research-and-Insights/Open-Doors/Data/International-Students/Fields-of-Study/Fields-of-Study-by-Place-of-Origin/2015-16.

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IV. Implications for American Policy

The above discussion about trends in Chinese industrial policy, the contradictions between promoting the US-China economic relationship and American national security, and the multiple paths by which China acquires technology are directly relevant to the current discussion in the United States about whether to reform its system to ensure that foreign investment does not harm American national security. It certainly makes sense for the U.S. Congress to consider reforming the operations of the Committee on Foreign Investment in the United States (CFIUS), but given the above discussion, I suggest that policymakers keep several points in mind that emerge from this analysis.

First, the United States should focus on limiting transfer of technologies that could harm American national security that China does not already possess and is not likely to develop internally. CFIUS's current focus on military-related technologies and critical infrastructure seems to be working relatively well. It may make sense to expand the scope of CFIUS to include certain kinds of data, but this determination should be made based on guidance from American national security professionals.

Second, to the extent CFIUS's mandate is expanded to other forms of investment, it may be most appropriate to consider having CFIUS review even investments where foreign parties obtain only a minority stake, particularly in cases of high-priority technologies. Obtaining majority stakes may not be necessary for Chinese and other foreign parties to obtain access to technologies which affect American national security. Some have suggested that this change would lead to a "slippery slope" that would induce misuse or retaliation by other countries against American investment and weaken the global economy. I am less concerned about this outcome as long the United States is careful and transparent about the need for this shift. On the other hand, I would not support expanding CFIUS's ambit to include outward American investment. Although certainly an avenue for important technology transfer, one that may increase in the years ahead, taking this step would likely be impractical. CFIUS currently reviews 100-150 cases per year; moreover, these cases all occur within a common jurisdiction well known to American regulators (their own). Expanding its coverage to outward US investment could raise that number to several thousand per year, certainly far more than could be effectively managed by the committee even if its resources were significantly expanded. And trying to gain understanding about each deal across many different regulatory environments would be beyond daunting.

Third, given that CFIUS needs should be reformed and not revolutionized, the United States should consider other policy and legislative options to address other potential weaknesses in oversight of American technology transfer to China and elsewhere. Particular focus should be placed on updating American export control rules, not only for physical technologies and intellectual property but for American employees who are then recruited by foreign industry.

Fourth, American efforts to constrain inappropriate technology diffusion to strategic rivals requires it to expand coordination with its allies in Europe and Asia. Differences in American policy and regulation differs from its allies can and have been exploited by jurisdictions subject

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to technology controls. Globalization of manufacturing and innovation is likely only to expand in the future, and so policy coordination must increase simultaneously.

And fifth, although it is important to protect the United States from the unwise transfer of technologies to countries that pose a security challenge to America, the United States also gains tremendous strength from having an economy open to flows of goods, services, people, and ideas. This is not just a nice-sound goal, but central to maintaining America's hard and soft power. Hence, policymakers should be careful that any steps taken to adjust technology investment have a net positive effect on the American economy and its potential future for high-productivity growth.

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Making Sense Of The South China Sea Dispute

Out of Asia, CONTRIBUTOR
Stories for expanding horizons. FULL BIO

POST WRITTEN BY
William Pesek
Pesek is a Tokyo-based journalist and the author of "Japanization: What the World Can Learn from Japan's Lost Decades."

The intensifying proxy war being waged in the South China Sea can be boiled down to one number: five. That's how many trillions of dollars of global trade flow annually through waters deep with oil, natural gas, hydrocarbon and fish stocks.

Whoever controls these shipping lanes rules this "Asian Century."

Toss national pride and ambition into the mix and you have the makings of a perfect geopolitical storm. Its winds coursed through Manila recently as senior officials from the 10 Association of Southeast Asian nations met at what, in less rancorous times, would've been a massive bash. ASEAN, as Asia's only real economic grouping calls itself, turns 50 this year.

Any celebratory impulses on hand were no match for tensions over Chinese encroachment. Beijing, which claims more than 80% of the South China Sea, is ramping up its military presence and accelerating construction on disputed desert islands, atolls and rocks populated only by goats, moles and birds. ASEAN members locked horns over specifically criticizing Beijing's landgrab in its communique.

This is a complicated and multifaceted saga. It hardly helps that the history of distant, largely uninhabited places with names like Paracel, Spratly and Scarborough Shoal differs from nation to nation. So, here's some background:

The Players

Data via the Asia Maritime Transparency Initiative; Design by Aliza Grant, Forbes Staff

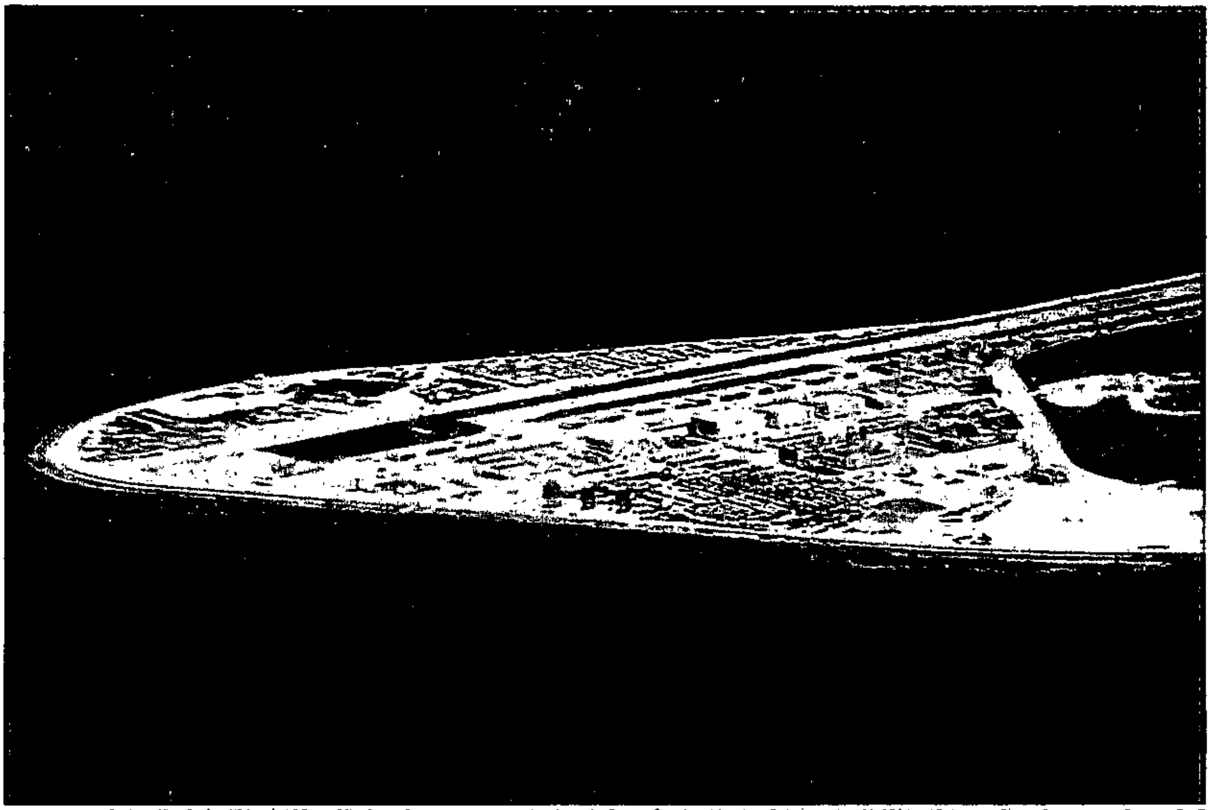
Brunei, China, Malaysia, the Philippines, Taiwan and Vietnam all have competing, in some cases overlapping, claims.

China is also engaged in century-old dispute with Japan 994 miles (1,600 kilometers) to the northeast over islands the Japanese call "Senkaku" and the Chinese call "Diaoyu." The U.S. role has largely been that of a policeman ensuring "freedom of navigation" is protected to keep the estimated $5.3 trillion of annual trade, as estimated by the Council on Foreign Relations, moving.

Read More: How China Can Avoid Following The Code Of Conduct

However, Donald Trump's arrival on the scene has pumped new drama into these standoffs. The U.S. president's secretary of state, Rex Tillerson, has compared

China's actions to Russia's annexation of Crimea and said it should be denied access to the artificial islands it insists it is not constructing. A red line or mere bluster?



FILE - In this April 21, 2017, file photo, Chinese structures and an airstrip on the man-made Subi Reef at the Spratly [+]

The History

Like territory disputes elsewhere, Asia's are partly rooted in the region's colonial history dating back many decades (or centuries, if you ask Beijing). What really upset the neighborhood is China in recent years moving to morph its claims into reality.

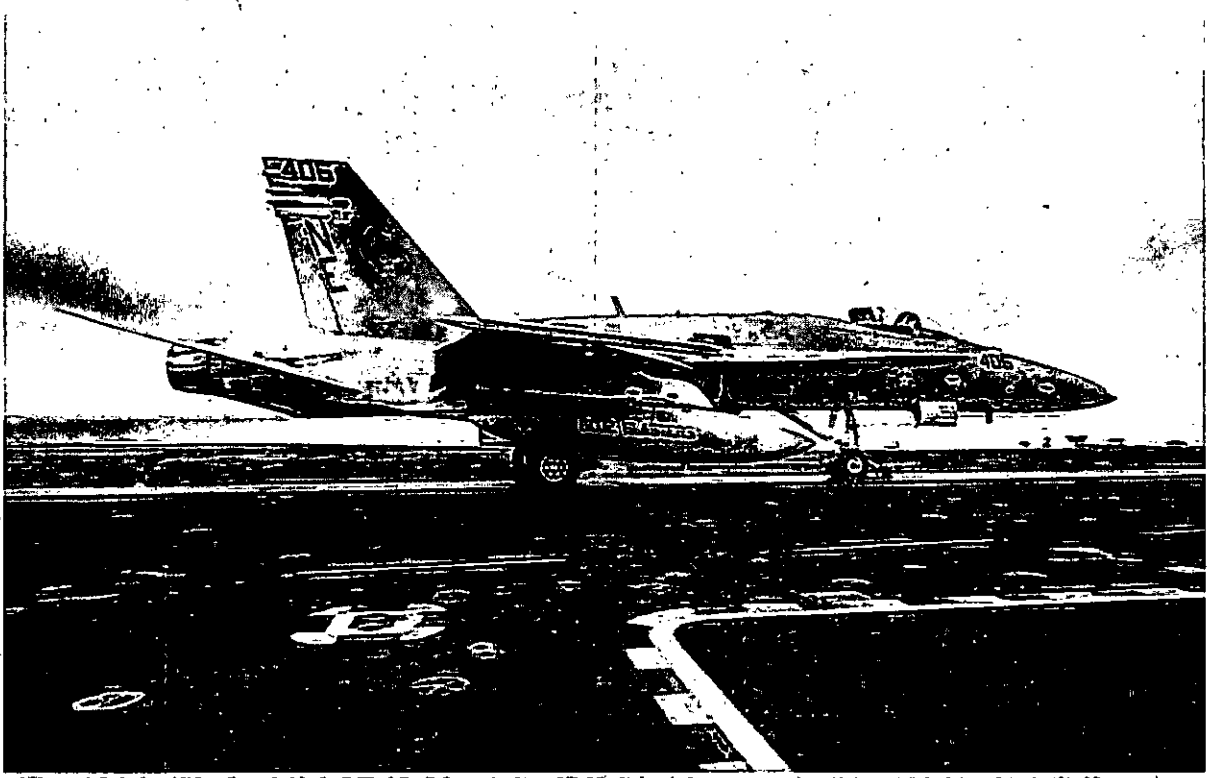
Beijing first outlined them in 1947 by sharing the first rendering of its "nine-dash line," extending roughly 1,118 miles (1,800 kilometers) from Hainan Island to the waters off equatorial Borneo. That blueprint is now coming to life around Asia.

In 2013, then-Philippine President Benigno Aquino effectively sued Beijing using a United Nations tribunal to allege violation of sovereign rights. It won the case in July 2016 just as China's growing military presence was becoming a hot U.S. presidential topic.

The State Of Play Now

Aquino's successor, Rodrigo Duterte, effectively forfeited Manila's UN victory and cozied up to Beijing. In Manila earlier this month, Cambodia did Chinese President Xi Jinping's bidding by working to water down criticism of Chinese expansionism. Vietnam took the opposite tack, pushing for ASEAN to take slam Xi's empire-building gambit. That stance reportedly had Chinese Foreign Minister Wang Yi canceling a one-on-one meeting with his Vietnamese counterpart.

Events on the ground in Manila speak to the delicate balancing act between small but proud nations pressing territorial claims against a rising giant that makes it clear it'll do what it pleases. China has weaponized trade by demanding a quid pro quo: If you cross us, you'll get less of a share in our economic rise.



The U.S. military has a significant presence across the South Chin Sea. (Mass Communication Specialist 3rd Class Matt Brown/U.S. Navy via Getty Images)

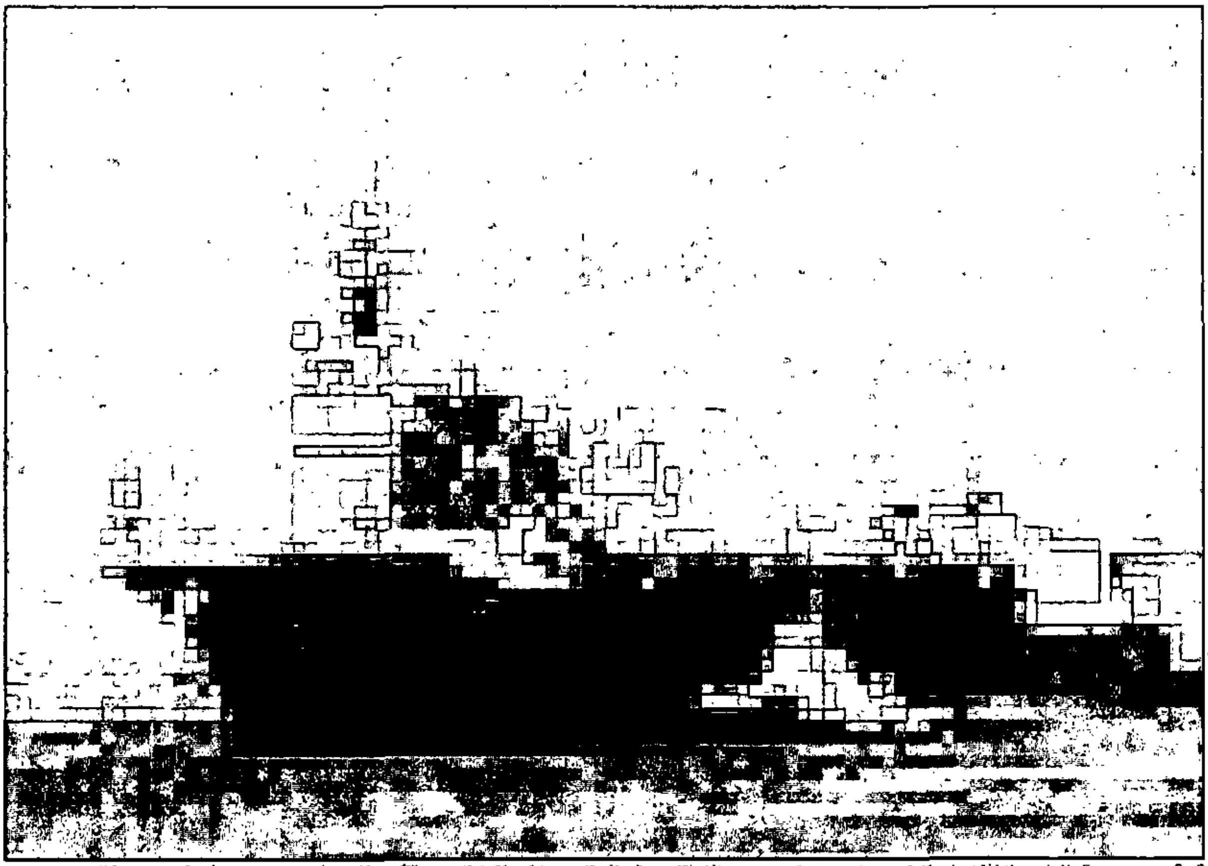
The Road Ahead

The stakes of this geostrategic standoff are rising with the number of naval ships, fighter jets and drones facing off in Asian seas. China's giant and opaque land reclamation projects are placing its military hardware throughout the region and pulling archrival Japan out of retirement. Prime Minister Shinzo Abe is working to shed Japan's post-war pacifism by amending the constitution. The odds of a mistake, miscalculation or miscommunication -- two aircraft or ships colliding, for example -- are rising.

Along with China's bullying tactics, North Korea's provocations have U.S. aircraft carriers increasingly showing up in the region. Having a growing number of military vessels and planes in such close proximity is inherently dangerous.

Read More: How Vietnam Will Lose The Most From A Code Of Conduct

None of this means war is imminent -- even likely. But potential flashpoints abound. What if Beijing and Tokyo -- or Beijing and Hanoi -- overreacted to some random incident? Or if a Trump White House on the ropes saw a minor skirmish in the Asian seas as a chance to wag the proverbial dog to change the narrative in Washington? It's impossible to know, says Howard French, author of "Everything Under the Heavens," how the world will respond to China "supplanting American power and influence" in Asian waters many see as "an irreplaceable stepping stone along the way to becoming a true global power in the 21st century."



Japanese helicopter carrier Ise at Subic port, north of Manila in April, 2016. Japanese PM Shinzo Abe is trying [+]

In recent years, Nouriel Roubini and other economists famed for predicting Black-Swan shocks ranked South China Sea threats higher than North Korea. Well, both dangers are reaching a fever pitch simultaneously, while nationalists Xi, Abe, Trump and Kim Jong Un look to flex muscles abroad.

The greatest irony is that the Asian century looks more like the era of General Dynamics, Northrop Grumman, Raytheon and the rest of the U.S. military-industrial complex racing to open offices around the region. These defense giants are positioning themselves for a piece of the greatest arms races since World War II, one that's just getting started.

As Asia lacks a European Union, NATO or other overarching authority to settle grievances, to keep this proxy war from becoming a real one, the rest of 2017 boils down to hope for the best -- but brace for the worst.

Summary

Since the mid-1990s, and particularly since 2012, tensions have spiked between Japan and China over the disputed Senkaku (Diaoyu/Diaoyutai) islands in the East China Sea. These flare-ups run the risk of involving the United States in an armed conflict in the region. Japan administers the eight small, uninhabited features, the largest of which is roughly 1.5 square miles. Some geologists believe the features sit near significant oil and natural gas deposits. China, as well as Taiwan, contests Japanese claims of sovereignty over the islands, which Japan calls the Senkaku-shoto, China calls the Diaoyu Dao, and Taiwan calls the Diaoyutai Lieyu. Although the disputed territory commonly is referred to as "islands," it is unclear if any of the features would meet the definition of "island" under international law.

U.S. Administrations going back at least to the Nixon Administration have stated that the United States takes no position on the question of who has sovereignty over the Senkakus (Diaoyu/Diaoyutai). It also has been U.S. policy since 1972, however, that the 1960 U.S.-Japan Security Treaty covers the islands. The treaty states that the United States is committed to "meet the common danger" of an armed attack on "the territories under the Administration of Japan," and Japan administers the Senkakus (Diaoyu/Diaoyutai). In return for U.S. security commitments, Japan grants the United States the right to station U.S. troops—which currently number around 50,000—at dozens of bases throughout the Japanese archipelago. Although it is commonly understood that Japan will assume the primary responsibility for the defense of the treaty area, in the event of a significant armed conflict with either China or Taiwan, most Japanese likely would expect that the United States would honor its treaty obligations.

Since 2012, without challenging the U.S. government's position of neutrality over who has sovereignty over the islands, Congress nevertheless has expanded rhetorical support for Japan on the dispute. Congress inserted in the FY2013 National Defense Authorization Act (H.R. 4310/P.L. 112-239) a resolution stating, among other items, that "the unilateral action of a third party will not affect the United States' acknowledgment of the administration of Japan over the Senkaku Islands." Following Congress's statement, Obama Administration officials began using similar language, also without changing U.S. neutrality on the sovereignty question. Most prominently, in April 2014, President Obama reiterated that Article 5 of the U.S.-Japan Security Treaty covers the islands and that "we do not believe that [the Senkakus' status] ... should be subject to change unilaterally." This is believed to be the first time a U.S. President publicly stated the U.S. position on the dispute.

In February 2017, during his first joint press appearance as President with Prime Minister Shinzo Abe, President Donald Trump stated that "we are committed to the security of Japan and all areas under its administrative control.... " A joint statement issued by the two governments during their summit said that the two leaders "affirmed that Article V of the U.S.-Japan Treaty of Mutual Cooperation and Security covers the Senkaku Islands. They oppose any unilateral action that seeks to undermine Japan's administration of these islands."

The expanded U.S. rhetorical support for Japan has been a reaction to China's increasing patrols around the Senkakus (Diaoyu/Diaoyutai) beginning in the fall of 2012, moves that appear to many to be an attempt to exploit the U.S. distinction between sovereignty and administrative control by demonstrating that Beijing has a degree of administrative control over the islands. In a further effort to deter Chinese actions, the United States has increased its support for Japan's efforts to boost its maritime and island defenses.

Each time tensions over the territorial dispute have flared, questions have arisen concerning the U.S. legal relationship to the islands. This report focuses on that issue.

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Security

What Kind of South China Sea Does China Need?

Aug 09 , 2017

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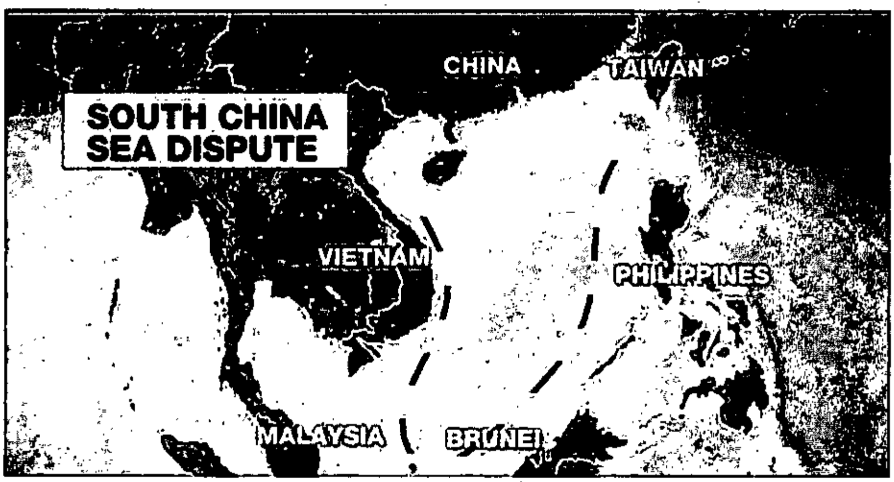

The United States Navy Destroyer –USS Dewey (DDG 105) sailed within 12 nautical miles of the Mischief Reef in Nansha Islands (Spratly Islands) on 24 May 2017, conducting what is commonly known as a Freedom of Navigation Operation (FONOP). In addition to domestic factors within the United States, this action of the USS Dewey was motivated by the desire to promote an international conception that the Mischief Reef is not an island, to avoid objectively acknowledging China's sovereignty over the Mischief Reef, to challenge China's sovereignty claims over the South China Sea, and to protect the United States Navy's vital interests, among others. These justifications bring into question whether the USS Dewey was truly making an "innocent passage."

This is the first time an FONOP has been conducted since President Donald Trump took office; a contrast to recent events in which China and the United States have gradually warmed ties and taken steps toward bilateral collaboration. The tension inspiring FONOPs are slated to continue; Defence Secretary James Mattis confirmed this during the Shangri-La Dialogue held in Singapore on June 5, 2017. The following month, another FONOP was conducted within 12 nautical miles of the Zhongjian (Triton) Island in Xisha (Paracel) Islands on July 2, 2017. Should they continue, FONOPs may also be further upgraded to "harmful passage." What then should China do: continue on the current approach, introduce a comprehensive response after careful calculation, or perhaps even take out the "big stick" of military might out when necessary?

An Analysis of China's South China Sea Stand

How should China deal with the South China Sea (SCS) issue? Its response mainly depends on how China views the SCS: As internal waters? As territorial sea? As territorial sea plus Exclusive Economic Zones? Territorial Waters plus Exclusive Economic Zones (including Continental Shelf) plus High Sea? Archipelagic Waters? High Sea?

China states that it, "has indisputable sovereignty over the South China Sea islands and their adjacent waters, as well as sovereign rights and jurisdiction over relevant seabed and subsoil,"[1] According to this statement, China has indisputable sovereignty over the South China Sea Islands (the Dongsha Islands, the Xisha Islands, the Zhongsha Islands and the Nansha Islands) and the adjacent waters." In another statement, China claimed, "China's sovereignty over Nanhai Zhudao and relevant rights and interests in the South China Sea have been established in the long course of history, and are solidly grounded in history and law."[2]

China therefore deems that there are no disputes over the island and reef ownerships and maritime rights in the Xisha Islands (Paracel Islands) and Zhongsha Islands, but admits there are disputes of such over the Nansha Islands (the Spratly Islands).

Maritime delimitation can only be carried out after determining the ownerships of islands and reefs. And so far, the Chinese mainland, China's Taiwan, Vietnam, Malaysia, and the Philippines have all taken control of some of the islands and reefs in the South China Sea. As many have professed, splitting the difference is the only way to a peaceful solution to the South China Sea issue. However, this is extremely difficult as it requires one or more of the claimants to cede their control over their islands and reefs.

China should consider the long-term consequences of war and carefully evaluate its necessity. The key to grasping the South China Sea issue is to acknowledge that it is a strategic issue first, a political issue second, and a legitimacy issue last. When dealing with SCS issue, China should go far beyond SCS. In other words, China should not only consider how to maximise its own interests in SCS, but how to advance China's rise as a comprehensive global power. This means that China must consider the South China Sea issue with a comprehensively, seriously contemplating the following questions:

1. Which is more important, the building of OBOR or the disputes over SCS?

OBOR is a top-level priority of foreign relations designed in a collaboration of the current Chinese government and long-term strategic planning. In this sense, the politics, diplomatic responses, and the legal instruments and so forth employed in resolving the South China Sea issue should all be serving OBOR. For the time being, SCS issue is in a relatively peaceful period. However, it is nonetheless a major concern to the regional security and stability, is a tool in the United States' "regional re-balancing strategy," and also affects the implementation of OBOR (especially the Maritime Silk Road) in the ASEAN countries, particularly the ASEAN claimants. For this reason, China's South China Sea policy should steer from pursuing a unilateral win to a multilateral win, and should attempt to bring forth a multilateral winning plan by taking the lead in the problem solving process. The next few years are a good window of time for China to establish a new South China Sea policy.

2. How can a balance be struck between building a regional strategic support belt and safeguarding the sovereignty and maritime rights of SCS?

It is not rare to find that the rise of a country causes security concerns to increase among its neighboring countries. In this process, gaining their favor is a necessary task. In order to achieve this, the rising country has to lessen its neighboring countries' security concerns and build up their trust. Whilst China's exercise in self-restraint is largely overlooked, the outside world is mainly focused on China's moves in safeguarding its rights, and tends to describe these moves as "assertive." To "force China to clarify its SCS claim" has already become one of the priorities of the United States' SCS strategy, and this has won numerous supports from a number of ASEAN countries.

As China is the largest coastal country along SCS, the other claimants are no match for China's capacity to resolve the South China Sea issue by force. If China could facilitate a multilateral winning plan that not only satisfies its own interests, but also takes into consideration those of the other claimants' concerns, then the security concerns of ASEAN countries, especially the ASEAN claimants will be much decreased and should consequently lessen their security reliance on other countries outside the region. This could also cause other neighboring countries to increase their trust in China.

3. How can the government consider both its global maritime interests and its interests in the South China Sea?

Overseas interest is quickly expanding, maritime interest is rapidly increasing, and a great "blue water navy" is in the making. But China's rise to a becoming a global power cannot be completed without the support of its maritime rights and interests. China's maritime claims should maximise its interests not only in coastal waters but also in global waters. Hence, China's maritime claims have to be universally applicable, so as to make China one of the main builders and leaders of the global maritime management regime and to provide the country with space to successfully maximise its maritime interests in global waters.

4. How is it possible to coordinate the maritime claims of the East China Sea, the South China Sea and the Yellow Sea, and use the South China Sea issue to support to the settlement of the Taiwan?

At present, China's maritime claims have not been made clear enough to the world. In regard to the Yellow Sea, China stresses international law, especially the equity principle. In the East China Sea, China continues its advocacy of UCLOS and places emphasis on the principle of natural extension of the continental shelf. In respect to SCS, China focuses on the application of both international law and historical rights of ownership.

A more realistic approach should guide the direction of China's new maritime policy: have the Yellow Sea claim based on the adjusted medium line, the East China Sea claim based on the combination of the medium line and the continental shelf, and the South China Sea claim based on international law and a clarified historic rights claim.

For China, the Taiwan question is undoubtedly more important than SCS issue, the East China Sea issue or the DPRK nuclear issue. But seeing as not much can be done in the case of the East China Sea or the DPRK nuclear problem the South China Sea becomes the primary option to act and its urgency becomes increasingly clear. Taking into account the intervention of the outside countries, especially the United States and Japan, on SCS issue, and Tsai Ing-wen's deep-rooted preference for "Taiwan's independence," in regard to the SCS issue, China should consider how to 'pull' the ASEAN countries close in order to prevent the East China Sea issue from becoming linked with SCS issue and not to "add a burden" to Taiwan discussion.

5. What role does South China Sea issue in the China-ASEAN relations?

In dealing with the South China Sea issue, the ASEAN countries, in particular the ASEAN claimants, are more focused on "controlling differences" whilst China is more concerned about "strengthening cooperation." To this end, both China and the ASEAN claimants have called for the creation of the "SCS Code of Conduct" (COC) as soon as possible. China, while deeming the settlement of SCS issue a long-term process and believing the COC unable to eliminate the dispute, introduced the "dual-track approach" and agreed to relatively speed up the drafting of COC framework. As a result, a framework document of COC was finally signed by China and the ASEAN countries on May 18, 2017. Remaining issues such as whether COC is legally binding, which maritime areas are applicable, whether a dispute settlement mechanism should be established and so forth are still left for further discussion.

If there is no breakthrough in the issues of the most concern to the relevant countries, the effectiveness of COC will be significantly affected. Further unilateral actions may also be a possibility, depending on China's capacities. In that case, the ASEAN countries are highly likely to strengthen security cooperation with outside countries especially the United States, a move that will then affect their economic and security cooperation with China. It is in this thinking that China must consider the option of entering a legally binding multilateral framework and promote the idea solving process of SCS issue within this framework.

could be more flexible gaining their interests and trusts, as well as lessen their security concerns while to the United States FONOPs, China should dare to confront them.

At the very least, from October 27, 2015 when the United States Navy Destroyer, USS Lassen sailed within 12 nautical miles of the Subi Reef in Nansha Islands, the United States' FONOPs have been a primary source of periodical tension in the South China Sea. China's response should be to send a warship to "identify and verify, warn and expel," which is exactly what occurred with the USS Dewey. This is obviously far from enough, and could very well result in the United States taking a yard when given an inch. In dealing with so-called FONOPs within 12 nautical miles, China must show its determination and clearly demonstrate to the United States that: this act is definitely a violation to the Chinese laws and a humiliation to a rising power. A mature superpower should not behave that way.

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[1] See the notes submitted by China to the Secretary General of the United Nations on May 7 2009 and April 14 2011, file number CML/17/2009 and CML/8/2011, respectively.

[2] See the Position Paper of the Government of the People's Republic of China on the Matter of Jurisdiction in the South China Sea Arbitration Initiated by the Republic of the Philippines published on December 7, 2014.

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Why a South China Sea Diplomatic Breakthrough Is Unlikely

How to Respond to Beijing's Continued Military Buildup

Gregory Poling

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On December 30, Chinese state television broadcast aerial footage [1] of the country's facilities on Fiery Cross Reef in the South China Sea [2]. The video was the first ever to show close-up images of the entirety of the substantial naval and air base on the disputed reef in the Spratly Islands. Earlier that month, the Center for Strategic and International Studies' Asia Maritime Transparency Initiative had released satellite imagery [3] documenting the construction of aircraft hangars, missile shelters, signals intelligence facilities, and other military infrastructure on Fiery Cross, as well as Mischief and Subi Reefs, throughout 2017. But the aerial footage highlighted the scale of China's military buildup in a visceral way that satellite imagery could not. It should have served as a wake-up call in both Manila and Washington that Beijing has not changed its long-term strategy of employing coercion and, if need be, military force to establish dominance over the South China Sea [4]. Despite diplomatic niceties and largely unrealistic talk of a code of conduct (COC) with fellow claimants, China's actions undermine the narrative that it is serious about finding an equitable diplomatic solution to the disputes any time soon.

ASSESSING BEIJING'S INTENTION

In the Philippines, the footage of Fiery Cross Reef sparked concern in the press and drew a confused response from the government. On January 8, Philippine Secretary of National Defense Delfin Lorenzana said that the placement of troops or weapons systems on Chinese-occupied reefs would be a violation of Beijing's 2015 pledge (made by Chinese President Xi Jinping to U.S. President Barack Obama [5]) not to militarize its outposts in the Spratlys. Lorenzana said that if such a move proved true, he would ask the Philippine Department of Foreign Affairs to make a diplomatic protest in response. But a day later, Philippine presidential spokesperson Harry Roque dismissed the idea [6] that China had done anything wrong. He insisted that Beijing was acting in "good faith" so long as it did not undertake reclamation on currently unoccupied islands and reefs, suggesting that a continued buildup on the seven Spratlys it already occupied was fine with Manila. These contradictory answers as to whether China had violated its commitments underscored an ongoing debate within the Philippines, and throughout much of Southeast Asia, over how to gauge Beijing's intention.

The January 17 innocent passage of the USS *Hopper* through the territorial sea of Scarborough Shoal provoked a similar difference of opinion [7]. The passage marked the first freedom of navigation operation near the shoal, control of which China seized from the Philippines in 2012, since the Freedom of Navigation Program's application in the South China Sea began attracting widespread attention in late 2015. In response, Roque called the matter a U.S.-China issue and said the Philippines wanted no part in it, despite claiming Scarborough Shoal as part of its territory. Lorenzana, on the other hand, was quick to defend the operation as entirely legal.

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The inauguration of Philippine President Rodrigo Duterte in June 2016 provided an opportunity that China gladly seized. The ideologically anti-American Duterte [8] quickly moved to shelve the landmark July 2016 arbitral award, which deemed Beijing's vast claims to historic rights in the South China Sea illegal and confirmed Manila's exclusive rights within the waters and seabed granted to it by international law. He also announced a "separation" of his country from the United States [9] on military and economic policy while seeking closer ties with China. So far, he has been constrained from moving this agenda too far by the military and civilian bureaucracies [10], members of the Philippine Congress, and public opinion, which remains broadly pro-American and distrustful of China [11]. Still, he continues to push a policy of rapprochement with Beijing—one in which Manila keeps quiet on points of disagreement in exchange for as-yet-unfulfilled [12] promises of increased investment and a peaceful management of disputes [13].

Since the fall of 2016, Beijing has extended a diplomatic olive branch to many Southeast Asian states and avoided provoking major new standoffs in the South China Sea. In May 2017, China's foreign ministry announced that negotiators had reached agreement on a draft "framework" [14] for a South China Sea COC between China and the members of the Association of Southeast Asian Nations (ASEAN). The foreign ministers of the 11 negotiating countries officially adopted the one-page framework in August 2017 and hope to start negotiations [15] on the COC itself in March 2018. Tensions remain in China's relationships with Indonesia, the Philippines, and, especially, Vietnam [16], but they have undeniably eased. The question is whether that progress marks a long-term strategic shift by Beijing or merely a tactical adjustment before the next round of escalation. In other words, is China really acting in good faith?

A POLICY OF COERCION

The debate between China skeptics and those promoting accommodation is not a uniquely Philippine phenomenon. It is happening in all nations that have a major role in the South China Sea disputes, including Indonesia, Singapore, Vietnam, and even the United States. After nearly a decade of steady escalation and no real prospects for resolving the maritime disputes, the allure of a sudden diplomatic breakthrough, however unlikely, and the willingness to bank on Chinese good faith to make it happen are understandable. The alternative would be to prepare for another years-long slog of rising military tensions, sporadic clashes, and diplomatic naming and shaming, with no guarantee of successful resolution.

Unfortunately, the facts do not support the hypothesis that China is prepared to forego military coercion and cut a fair deal with its neighbors. Over the course of 2017, while talking up diplomatic efforts its fellow claimants, China built facilities [3] covering about 72 acres, or 290,000 square meters, of land in the disputed Spratly and Paracel Islands. The largest of its outposts in the Spratlys, on Fiery Cross, Mischief, and Subi Reefs, now sport large underground facilities to store the water, fuel, and ammunition necessary for substantial naval and air bases. Each of the outposts is bristling with new radars, sensors, and other signals intelligence capabilities to ensure that nothing moves in the South China Sea without Beijing's knowledge. Operations by People's Liberation Army Air Force fighter jets and military transport planes in the Paracels in October and November of last year presaged things to come in the Spratlys, where 72 hangars for fighter jets and about a dozen for larger aircraft are awaiting the first deployments. And hardened shelters stand ready to house the mobile missile platforms that will protect these offensive capabilities from retaliation by the United States or regional parties.

Nor did China remain entirely placid while improving its military bases in 2017. In August, Beijing deployed a flotilla of military and civilian ships off Philippines-occupied Thitu Island, which houses about 100 civilians, in response to the landing of Filipino fishers on an unoccupied sand cay nearby. Chinese operators had previously warned away a plane carrying Lorenzana on a visit to the island in April, insisting he was flying through Chinese airspace. At the time, the defense secretary responded by brushing off the incident, telling the press that it happens whenever [17] a Philippine plane lands on Thitu. Also in April, personnel aboard a China Coast Guard vessel reportedly shot at

Filipino fishers [18] near an unoccupied disputed reef. Throughout the year, China Coast Guard vessels maintained a regular presence at Luconia Shoals [19] off the coast of Malaysia and at Scarborough Shoal, where Filipino fishers were allowed to operate around the reef under the watchful eye (and occasional harassment [20]) of Chinese personnel but not enter the cordoned off lagoon controlled by China. Most worryingly, in July the Chinese government reportedly threatened military force [21] to prevent Vietnam from moving forward with oil and gas drilling by a Spanish company, Repsol, on Vanguard Bank—a piece of the seabed at the southern edge of China's vague "nine-dash line," which it uses to demarcate its maritime claim. Hanoi was forced to suspend Repsol's contract after it had already spent hundreds of millions of dollars on exploration and drilling.

Policymakers such as Roque and Philippine Secretary of Foreign Affairs Alan Peter Cayetano have ignored or explained away these instances of coercive behavior and continued militarization because they consider them relatively unimportant when weighed against the prospect of finally negotiating a COC. With a framework agreement in hand and talks expected to begin in March, that sentiment is understandable but premature. The framework agreement amounts to a single page of generalities [22] and ellipses. It does not touch upon any of the most difficult issues that need to be reconciled for a COC to be effective, and China has given no indication that it is prepared to compromise on any of them.

Much debate has surrounded whether Beijing will agree to make the COC legally binding [23]—something which is not discussed in the framework but seems integral to an effective agreement. But that is not necessarily the most difficult issue to resolve, nor the most important. For instance, there is no indication that states are on the same page about where the COC will apply. Will it encompass the Paracels as well as the Spratlys? What about places such as Vanguard Bank that only China sees as disputed? Official discussions have not even begun to touch on details such as fisheries management, joint development of oil and gas, environmental protection, or law enforcement in disputed waters. How will states reconcile China's claim to historic rights with their own domestic and international laws? And how will disagreements over interpretation of the code be resolved?

None of these issues are unsolvable, but even if all the parties are committed to working them out, reconciling them will likely take years. In the decade and a half since China and the ASEAN states signed the non-binding Declaration on the Conduct of Parties in the South China Sea, in 2002, they have made no appreciable progress on any of these topics. Difficult issues were not even included in the framework negotiations last year because they would have made it impossible to reach the parties' self-imposed midyear deadline. To break this logjam and reach an effective agreement in a reasonable time frame—for instance in the few years left before a devastating fisheries collapse [24] takes place in the South China Sea—would require a radical shift in positions and a willingness to make broad concessions. This is especially true for China and its far-reaching but ambiguous claim to historic rights.

Unfortunately, it is hard to reconcile the idea that such will might exist in Beijing with the continued military buildup and coercive tactics seen throughout 2017. The most optimistic conclusion is that China's government is of two minds on the South China Sea—willing to flirt with diplomatic efforts while simultaneously seeking dominance over its neighbors through military and paramilitary means. The more cynical view is that the diplomatic outreach of the last year and a half has been primarily a delaying tactic [25] meant to distract Southeast Asian claimants and deflect external criticism while Beijing prepares for the next cycle of military escalation.

A CREDIBLE DETERRENT

Across Asian capitals and in Washington, pragmatists would welcome a sudden diplomatic breakthrough, but it would be a mistake to count on China's good faith amid so many negative signs. The chances of concluding an effective COC in the short term appear dim. Meanwhile, it

seems likely that Chinese combat aircraft will soon begin operating regularly from air bases in the Spratly Islands, working in tandem with an ever-growing naval and paramilitary presence to enforce Beijing's claims at the expense of those of its neighbors.

Since 2016, China has steadily increased its power projection capabilities throughout the nine-dash line while the relative positions of Southeast Asian claimants and outside parties like the United States have eroded. In Manila, the defense secretary and other cool heads have mitigated the worst impulses of those determined to pursue détente with China at any cost. This has included salvaging the defense relationship with the United States, at least partially in preparation for the day when China's aggressive pursuit of its claims leads to a new round of standoffs and clashes.

For its part, the Trump administration's narrow focus on the current crisis in North Korea has left little time or energy for tackling a future crisis in the South China Sea. The State Department has reduced the issue to a secondary concern in diplomatic engagements with regional partners, and the White House has made no effort to formulate a whole-of-government strategy on the disputes. The Department of Defense has regularized freedom of navigation operations, but that has little effect in isolation. The U.S. military is returning to a regular tempo of training and joint exercises with the Armed Forces of the Philippines and continues to provide funds for capacity building. But the Enhanced Defense Cooperation Agreement [26], which was signed in 2014 to give U.S. forces limited access to Philippine bases, is being only partially implemented and is unlikely to enable a credible U.S. response to Chinese deployments in the Spratlys.

The evidence suggests that China is poised for new escalations in the South China Sea, which should serve as a wake-up call for governments in the Philippines and across the region. That will present both a challenge and an opportunity for the United States, but so far Washington is doing too little to prepare for either. To credibly deter China from using force, or even the threat of force as a coercive measure, against the Philippines, the United States will need to have combat aircraft and other assets forward deployed in the country. That means getting EDCA back on track, especially by convincing the Duterte government to follow through on plans to allow upgrades at all five previously agreed-upon bases, reverse its decision to ban the storage of ammunition at them, and permit a regular schedule of U.S. combat aircraft rotations. It is also time for the U.S. government to publicly state that its commitment to defend Philippine troops, ships, and planes from attack under Article V of the two countries' Mutual Defense Treaty applies to contested waters and islands in the South China Sea. That clarification would not only reassure the Duterte government that the United States would actually back the Philippines when needed but would act as a strong deterrent to Chinese aggression.

A credible U.S. deterrent in the Philippines combined with regular U.S. operations in the South China Sea and sustained funding for capacity building and joint training for all the Southeast Asian claimants is necessary to prevent Chinese dominance by coercion in the short term. There is no military solution to the disputes, however, and any long-term U.S. strategy needs to be driven by the White House and the State Department, not the Pentagon. That means a multi-year, interagency effort to support Southeast Asian claimants, rally international support, and name and shame China. But first, the United States will need to reassure the region that it has not lost sight of the issue's importance, and will not in the future. For starters, U.S. officials should begin giving the South China Sea as much attention as North Korea during diplomatic engagements with ASEAN states and other regional partners. They should also make clear during public statements that U.S. interests in the dispute are not limited to its ability to "fly, sail, and operate" in those waters—which by itself means little to regional states—but, just as important, include the security of partners and allies and the defense of rules-based order in the face of Chinese revisionism.

CRS - China Naval Modernization: Implications for U.S. Navy Capabilities—Background and Issues for Congress
Ronald O'Rourke, Specialist in Naval Affairs May 21, 2018

Summary

The question of how the United States should respond to China's military modernization effort, including its naval modernization effort, is a key issue in U.S. defense planning and budgeting.

China has been steadily building a modern and powerful navy since the early to mid-1990s. China's navy has become a formidable military force within China's near-seas region, and it is conducting a growing number of operations in more-distant waters, including the broader waters of the Western Pacific, the Indian Ocean, and waters around Europe.

Observers view China's improving naval capabilities as posing a challenge in the Western Pacific to the U.S. Navy's ability to achieve and maintain control of blue-water ocean areas in wartime—the first such challenge the U.S. Navy has faced since the end of the Cold War. More broadly, these observers view China's naval capabilities as a key element of a broader Chinese military challenge to the long-standing status of the United States as the leading military power in the Western Pacific.

China's naval modernization effort encompasses a wide array of platform and weapon acquisition programs, including anti-ship ballistic missiles (ASBMs), anti-ship cruise missiles (ASCMs), submarines, surface ships, aircraft, unmanned vehicles (UVs), and supporting C4ISR (command and control, communications, computers, intelligence, surveillance, and reconnaissance) systems. China's naval modernization effort also includes improvements in maintenance and logistics, doctrine, personnel quality, education and training, and exercises.

Observers believe China's naval modernization effort is oriented toward developing capabilities for doing the following: addressing the situation with Taiwan militarily, if need be; asserting and defending China's territorial claims in the South China Sea and East China Sea, and more generally, achieving a greater degree of control or domination over the SCS; enforcing China's view that it has the right to regulate foreign military activities in its 200-mile maritime exclusive economic zone (EEZ); defending China's commercial sea lines of communication (SLOCs), particularly those linking China to the Persian Gulf; displacing U.S. influence in the Western Pacific; and asserting China's status as a leading regional power and major world power.

Consistent with these goals, observers believe China wants its military to be capable of acting as an anti-access/area-denial (A2/AD) force—a force that can deter U.S. intervention in a conflict in China's near-seas region over Taiwan or some other issue, or failing that, delay the arrival or reduce the effectiveness of intervening U.S. forces. Additional missions for China's navy include conducting maritime security (including antipiracy) operations, evacuating Chinese nationals from foreign countries when necessary, and conducting humanitarian assistance/disaster response (HA/DR) operations.

Potential oversight issues for Congress include the following:

- whether the U.S. Navy in coming years will be large enough and capable enough to adequately counter improved Chinese maritime A2/AD forces while also adequately performing other missions around the world;
- whether the Navy's plans for developing and procuring long-range carrier-based aircraft and long-range ship- and aircraft-launched weapons are appropriate and adequate;
- whether the Navy can effectively counter Chinese ASBMs and submarines; and
- whether the Navy, in response to China's maritime A2/AD capabilities, should shift over time to a more distributed fleet architecture.

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The Heritage Foundation

REPORT Defense

Sounding the Warning: DOD Report Examines the Growing Security Challenge from China

June 21, 2017 4 min read

Dean Cheng
Senior Research Fellow, Asian Studies Center

SUMMARY

The annual Department of Defense report on Chinese military and security development makes clear that China's military capabilities are steadily expanding in every potential warfighting domain: land, sea, air, outer space, and information space. The Chinese are clearly intent upon dominating the western Pacific in order to secure their environment. This will affect not only U.S. allies, but the United States itself. America needs to respond by reassuring our allies and deterring potential adversaries.

KEY TAKEAWAYS

China is expanding in every potential warfighting domain: land, sea, air, outer space, and information space.

The Chinese are clearly intent upon dominating the western Pacific in order to secure their environment.

The PLA Strategic Support Force will likely undertake missions to help establish dominance of the key domains of outer space and cyber space.

Consistent with the fiscal year 2000 National Defense Authorization Act (NDAA), the Department of Defense (DOD) recently released its annual report to Congress on Chinese military and security developments. The report lays out the official views of the DOD and the U.S. intelligence community on the state of the Chinese military and Chinese security activities. Its issuance has been protested annually by the People's Republic of China (PRC) as furthering perceptions of a "China threat."

The report makes clear that China's military capabilities are steadily expanding in every potential warfighting domain: land, sea, air, outer space, and information space.

In the air, the PLA Air Force is fielding two new fifth-generation (i.e., stealthy, advanced maneuverability) fighters, air-launched cruise missiles, and a variety of support aircraft, such as airborne early warning and electronic-warfare aircraft essential for modern air operations. In addition, China is developing a new long-range bomber, which will potentially have both nuclear and conventional roles.

At sea, the PLA Navy is deploying multiple new classes of submarines and surface combatants. It is also expanding its fleet of amphibious ships, with implications for the East and South China Sea, as well as Taiwan. China has already launched an indigenously produced aircraft carrier to complement the Liaoning, which is already in service.

On the ground, the PLA Army is deploying a range of new systems from tracked and wheeled self-propelled artillery to a variety of armored fighting vehicles.

Responsible for China's nuclear deterrent, the PLA Rocket Forces is now deploying MIRV'd intercontinental ballistic missiles (ICBMs) that are capable of hitting multiple targets, new mobile ICBMs (the DF-41), and medium-range and intermediate-range ballistic missiles that can reach Guam and the central Indian Ocean with both nuclear and conventional warheads.

The new PLA Strategic Support Force (PLASSF), responsible for operations in space and in the information domain, will have at its disposal a variety of new satellite systems. It will also be incorporating various cyber warfare units, such as Unit 61398, previously identified as a PLA unit engaged in economic cyber espionage.

The report provides some much-needed insight into these various growing capabilities, especially the PLASSF, which is central to the PLA's focus on fighting and winning future

"informatized local wars." The PLASSF will likely undertake key missions to help establish dominance of the key domains of outer space and cyber space in the event of conflict.

The implications of this new PLASSF, and the broader PLA modernization effort, are significant. The report discusses China's disregard for the U.N. Convention on the Law of the Sea (UNCLOS) and the associated Permanent Court of Arbitration (PCA) rulings on China's maritime claims in the South China Sea. The Philippines, a member of UNCLOS, had filed the complaint with the PCA, under the terms of UNCLOS; Beijing (also a signatory to UNCLOS) ignored both the filing and the subsequent findings, which were overwhelmingly opposed to China's positions. Indeed, China is now fortifying many of the artificial islands it has built in the area, despite the promise of Chinese President Xi Jinping to President Barack Obama that China would not "militarize" the islands. China's decision to ignore the PCA makes clear that it will act as it sees fit to defend its perceived national interests, even when they infringe upon international common spaces that are covered by international agreements and solemn promises.

For the United States, the report highlights the ongoing need to reassure our allies and deter potential adversaries. While the report itself does not contain policy recommendations, certain courses of action are necessary.

Continue publishing the annual report. One of the most important actions is to continue to produce the report. Beijing has worked assiduously for the past 17 years to have the United States cease its production, arguing that it jeopardizes U.S.–China relations and only gives ammunition to the "China threat" perspective. The report provides the world with the American point of view, including detailing China's military modernization efforts, and is an essential means of providing scholars, analysts, and policymakers with an up-to-date, reliable, authoritative source of information about the PLA and PRC security policy. Suspending the report would signal that the United States is prepared to defer to China on the presentation of even basic facts.

Establish a more robust presence. For three years, from 2012–2015, the United States conducted no Freedom of Navigation Operations (FONOPs) in the South China Sea, even as China was busily constructing artificial islands. In the subsequent two years, the United States only conducted a handful of "innocent passage" operations, which muddied, rather than clarified, the American position, as they seemingly endorsed China's position that its artificial islands exert a 12-nautical-mile territorial sea claim. It is time to reverse this trend, as with the

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USS Dewey's recent FONOP near Mischief Reef, not with a single passage, but with sufficient numbers of them to make clear that this is routine and normal behavior.

Improve U.S. military readiness. A robust presence demands forces capable of undertaking sailings, flights, and military deployments on a regular basis. Unfortunately, it is clear from recent testimony by top U.S. military leaders that the forces available for action in Asia are grossly deficient in readiness. Any meaningful "pivot" must start with the forces on hand being properly trained and equipped before any expansion of capabilities can be contemplated. Confronted with another "hollow military," it is vital that readiness of the available American forces be improved if they are to successfully deter the rapidly modernizing Chinese military.

Address sequestration. The decline in readiness is due, in no small part, to Congress and the President being unable to address the broader budget. Secretary of Defense James Mattis has called upon Congress to pass a defense budget, but that will only improve the situation if the larger budget is also addressed—including ending sequestration. Congress needs to face the hard choices involved in balancing military and non-military demands—and the larger issue of entitlements that looms over all.

The Chinese are clearly intent upon dominating the western Pacific in order to secure their environment. This will affect not only U.S. allies, but the United States itself. How will America respond?

—Dean Cheng is a Senior Research Fellow in the Asian Studies Center, of the Kathryn and Shelby Cullom Davis Institute, at The Heritage Foundation.

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Summary

China is building a modern and regionally powerful military with a modest but growing capability for conducting operations away from China's immediate periphery. The question of how the United States should respond to China's military modernization effort is a central issue in U.S. defense planning and foreign policy. Congress' decisions on this issue could affect U.S. defense strategy, budgets, plans, and programs, and the U.S. defense industrial base.

China has engaged in a sustained and broad effort over more than 20 years to transform its military, the People's Liberation Army (PLA), from an infantry-heavy, low-technology military into a high-technology, networked force with an increasing emphasis on joint operations and naval and air power. China has emphasized quality over quantity during this modernization: the number of military personnel and certain platforms (e.g., aircraft, tanks, certain vessels) has declined even as overall capabilities have improved.

From 2005 through 2014, China's official military budget increased at an average rate of 9.5% per year in real terms, allowing the PLA to improve its capabilities in many dimensions. PLA naval forces feature quieter submarines, large surface combatants with improved air defenses and long-range anti-ship cruise missiles, and a nascent aircraft carrier program. New air power capabilities include modern fighter aircraft, more supporting platforms and a variety of unmanned aerial vehicles (UAVs) in production and under development. The PLA has increased the number and accuracy of its ballistic missiles for both nuclear and conventional strike missions. China has launched numerous satellites for military communications, surveillance, and navigation, and also has developed a variety of counter-space capabilities. The cyber operations of the PLA are harder to characterize in detail, but reports indicate that China has invested heavily in this area.

Despite the acquisition of modern equipment, the PLA has weaknesses and limitations that constrain the effectiveness of its operations, including training, jointness, human capital, and logistics. The short war with Vietnam in 1979 was China's last major conflict, and the PLA has not been involved in sustained combat since the Korean War (1950-1953) and a limited border war with India (1962). Although PLA planning and force posture is concentrated on contingencies in China's periphery, including the East China Sea and South China Sea, since the late 2000s the PLA has expanded the geographic scope of its operations.

Many American China-watchers assert that China's main reason for strengthening the PLA is to ensure that the status of Taiwan is resolved on terms favorable to Beijing. Experts believe that other reasons for China's military modernization are to weaken the U.S. network of alliances and to become the leading regional power in a more multipolar East Asia. Experts emphasize the improvements in China's anti-access/area-denial (A2/AD) capabilities—modern aircraft, vessels, and missiles that can prevent opposing militaries from operating freely in the skies and seas near China, and can prevent reinforcements from arriving.

Congress could choose to address the issue of China's changing military capabilities through hearings, authorizing and policy legislation, defense budget allocations, and other means. Some examples of past legislation with significant, continuing impacts include the 1979 Taiwan Relations Act; the 1991 law prohibiting U.S. arms exports to China; and the National Defense Authorization Act (NDAA) for FY2000, which sets guidelines for U.S.-China military-to-military contacts. In recent hearings, resolutions, and laws, especially NDAAs, Congress has provided prescriptions and guidance regarding U.S. policy toward Asia-Pacific security issues. Budget allocations for specific U.S. defense programs might also be tied to assessments of China's military capabilities and intentions.

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SPECIAL NOTE AS TO LEGISLATION AFFECTING TAIWAN AS WELL AS U.S.-PRC RELATIONS

Set out below are provisions from the Taiwan Travel Act. Sponsored by Representative Steve Chabot (R-OH), the bill passed the House on January 9, 2018 by suspension of the rules. On February 12, 2012, the bill was reported from the Senate Foreign Relations Committee. It passed the Senate on February 28, 2018 and the President signed it into law on March 16, 2018. The Chinese Government is deeply concerned about this legislation, believing its provisions calling for high level official contacts between the United States and Taiwan contradicts the core principles under which China and the United States established diplomatic relations.

I wish to offer a perspective on this matter. Last year, I published A Legislative History of the Taiwan Relations Act: Bridging the Strait. From my research, I learned that China required three things of the United States in the course of 1978 normalization negotiations. These three conditions were:

1. End diplomatic ties to the Republic of China (Taiwan)
2. End a Mutual Defense Treaty (in effect since 1954) between the ROC and the United States
3. Withdraw any U.S. military forces from Taiwan (there were at the time U.S. forces based on Taiwan, although these had been reduced since the time of President Nixon's 1972 trip to China. At one time, the U.S. contingent included more than 10,000 troops plus sundry intelligence operations)

Although discussions on normalization proceeded gingerly, and not particularly productively, during the Nixon and Ford Administrations, they accelerated under President Carter. In 1977, Secretary of State Cyrus Vance visited China. In meetings with senior Chinese leaders (including Hua Guofeng and Deng Xiaoping), Vance explored the possibility of keeping an official U.S. presence on Taiwan and proposed the U.S. maintain a liaison office.

The Chinese leadership firmly rejected that idea. Deng told Vance, "You want an Embassy that does not have a sign on its door." President Carter and his senior advisors concluded that maintaining official ties in any form would normalization. Therefore, the United States agreed to maintain unofficial relations with Taiwan through the mechanism of the American Institute on Taiwan. In so doing, the U.S. followed a model Japan had used since 1972 when it recognized the PRC as the legitimate government of China.

Agreement on these conditions paved the way for normalization negotiations to conclude successfully. On December 15, 1978, the American and Chinese Governments simultaneously announced opening of relations. Diplomatic relations began on January 1, 1979.

Congressional deliberations on Taiwan legislation began soon thereafter. President Carter signed the Taiwan Relations Act on April 10, 1979. It provided a framework for maintaining economic and cultural ties with Taiwan and contained defense-related provisions falling short of ironclad commitments or treaty-like obligations. In both the Senate and House, amendments were offered that would have solidified the defense posture or elevated the Taiwan relationship to an official level. These amendments all failed.

The core principal in U.S.-China relations, as reflected in the three conditions, is the One China policy. This concept is central to three bilateral diplomatic documents: the Shanghai Communique of February 28, 1972, the Joint Communique on the Establishment of Diplomatic Relations of December 16, 1978, and the Joint Communique of August 17, 1982.

The 1982 Joint cCommunique further addressed the issue of arms sales to Taiwan, which was an area of disagreement that nearly derailed 1979 normalization discussions, and which the parties deferred for later understandings so that normalization could move forward. The 1982 Communique indicated the United States did not have a policy of continuing such sales indefinitely, and that the volume of such sales would not exceed, in quality or quantity the level of arms supplied in the three years since relations were normalized.

After the 1982 Joint Communique, the United States offered six assurances to Taiwan. These were:

- The U.S. and PRC had not agreed on a set date to terminate arms sales
- The U.S. would not mediate between Taiwan and the PRC
- The U.S. would not pressure Taiwan to negotiate with the PRC
- The U.S. position on sovereignty over Taiwan had not changed ("The United States acknowledges that all Chinese on either side of the Taiwan Strait maintain there is but one China and that Taiwan is part of China. The United States does not challenge that position. It reaffirms its interest in a peaceful settlement of the Taiwan question by the Chinese themselves." – from the Shanghai Communique of 1972
- No revisions would be sought to the Taiwan Relations Act, and
- The U.S. would not engage in prior consultations with the PRC on arms sales to Taiwan.

After appearing to cast doubt on the One China Policy during the transition, President Trump embraced it early last year. Doing so led to the successful meeting he had with President Xi Jinping at Mar-a-Lago and a summit in Beijing last November.

The Chinese argue that the Taiwan Travel Act is highly problematic because it recommends the reengagement of high-level civilian and military contacts characteristic of government-to-government relations. They contend that executing these policies would contradict the three communiques, including the One China policy.

Here is the text of the Taiwan Travel Act

AN ACT

To encourage visits between the United States and Taiwan at all levels, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE.

This Act may be cited as the "Taiwan Travel Act".

SEC. 2. FINDINGS.

Congress finds the following:

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(1) The Taiwan Relations Act (22 U.S.C. 3301 et seq.), enacted in 1979, has continued for 37 years to be a cornerstone of relations between the United States and Taiwan and has served as an anchor for peace and security in the Western Pacific area.

(2) The Taiwan Relations Act declares that peace and stability in the Western Pacific area are in the political, security, and economic interests of the United States and are matters of international concern.

(3) The United States considers any effort to determine the future of Taiwan by other than peaceful means, including by boycotts or embargoes, a threat to the peace and security of the Western Pacific area and of grave concern to the United States.

(4) Taiwan has succeeded in a momentous transition to democracy beginning in the late 1980s and has been a beacon of democracy in Asia, and Taiwan's democratic achievements inspire many countries and people in the region.

(5) Visits to a country by United States Cabinet members and other high-ranking officials are an indicator of the breadth and depth of ties between the United States and such country.

(6) Since the enactment of the Taiwan Relations Act, relations between the United States and Taiwan have suffered from insufficient high-level communication due to the self-imposed restrictions that the United States maintains on high-level visits with Taiwan.

SEC. 3. SENSE OF CONGRESS; STATEMENT OF POLICY.

(a) SENSE OF CONGRESS.—It is the sense of Congress that the United States Government should encourage visits between officials from the United States and Taiwan at all levels.

(b) STATEMENT OF POLICY.—It should be the policy of the United States to—

(1) allow officials at all levels of the United States Government, including Cabinet-level national security officials, general officers, and other executive branch officials, to travel to Taiwan to meet their Taiwanese counterparts;

(2) allow high-level officials of Taiwan to enter the United States, under conditions which demonstrate appropriate respect for the dignity of such officials, and to meet with officials of the United States, including officials from the Department of State and the Department of Defense and other Cabinet agencies; and

(3) encourage the Taipei Economic and Cultural Representative Office, and any other instrumentality established by Taiwan, to conduct business in the United States, including activities which involve participation by Members of Congress, officials of Federal, State, or local governments of the United States, or any high-level official of Taiwan.

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Opening Statement of the Honorable Ed Royce (R-CA), Chairman
Subcommittee on Asia and the Pacific Hearing:
"Reinforcing the U.S.-Taiwan Relationship"
April 17, 2018
(As prepared for delivery)

Thank you, Chairman Yoho for holding this important hearing on Taiwan. Over the last several months, we have seen many positive developments in the U.S-Taiwan relationship. The Taiwan Travel Act, for which I was an original co-sponsor, was signed into law by the President, and this was deeply appreciated by the Taiwan people.

It was a message I heard time and again when I was in Taipei over the Easter recess for meetings with President Tsai and other members of her cabinet. I believe that by encouraging more frequent visits between our two governments – including at the highest levels – we will further strengthen the critical U.S.-Taiwan partnership. That is why I make a point as Chairman to visit Taiwan every year.

I have always been a champion for strengthening Taiwan's economic and people-to-people links from the grassroots level on up to the high-level policy making in Washington. Last month, I took the inaugural China Airlines daily, non-stop flight from Ontario, California to Taoyuan Airport in Taiwan. This was built upon the years of work in supporting linkages between U.S. and Taiwan through the Visa Waiver and Global Entry Program in 2012 and 2017 respectively. These programs have already translated into new growth with travel volume between the U.S. and Taiwan increasing by more than 50 percent.

Perhaps most pressing today is Taiwan's inclusion at the World Health Assembly meeting next month. Over the years, Taiwan has contributed to international efforts to improve global health with financial and technical assistance. However, it was excluded from the meeting last year after eight consecutive years of being able to observe the meetings. Keeping Taiwan out can only hurt global health, and there should be no question about its participation this year.

Over the weekend, the New York Times ran an article that named Taiwan as the new bastion of free speech in Asia. Indeed, I have seen this with my own eyes. The U.S. and Taiwan's shared commitment to democracy, human rights, and rule of law serve as the bedrock of this partnership, so I am glad we are here today to discuss how we can reinforce this important relationship.

Thank you again Chairman Yoho. I look forward to hearing the witnesses' testimonies.

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Summary

Despite broadly consistent statements, the U.S. "one China" policy concerning Taiwan remains somewhat ambiguous and subject to different interpretations. Apart from questions about what the policy entails, issues have arisen about whether U.S. Presidents have stated clear positions and have changed or should change policy, affecting U.S. interests in security and democracy. This CRS Report, updated through the 113th Congress, analyzes the "one China" policy since U.S. Presidents began in 1971 to reach understandings with the People's Republic of China (PRC). Taiwan calls itself the Republic of China (ROC) and does not recognize the PRC. There are three sets of issues: sovereignty over Taiwan; PRC use of force or coercion against Taiwan; and cross-strait dialogue. The United States recognized the ROC until the end of 1978 and has maintained non-diplomatic engagement with Taiwan after recognition of the PRC in 1979. The State Department claims an "unofficial" relationship with Taiwan. The United States did not explicitly state Taiwan's status in the U.S.-PRC Joint Communiques of 1972, 1979, and 1982. The United States "acknowledged" the "one China" position of both sides of the Taiwan Strait.

Since 1971, U.S. Presidents—both secretly and publicly—have articulated a "one China" *policy* in understandings with the PRC. Congressional oversight has watched for any new agreements and any shift in the U.S. stance closer to that of Beijing's "one China" *principle*—on questions of sovereignty, arms sales, or dialogue. Not recognizing the PRC's claim over Taiwan or Taiwan as a sovereign state, U.S. policy has considered Taiwan's status as unsettled. With added conditions, U.S. policy leaves the Taiwan question to be resolved by the people on both sides of the strait: a "peaceful resolution" with the assent of Taiwan's people and without unilateral changes. In short, U.S. policy focuses on the *process* of resolution of the Taiwan question, not any set outcome.

The Taiwan Relations Act (TRA) of 1979, P.L. 96-8, has governed U.S. policy in the absence of a diplomatic relationship or a defense treaty. The TRA stipulates the expectation that the future of Taiwan "will be determined" by peaceful means. The TRA specifies that it is U.S. policy, among the stipulations: to consider any non-peaceful means to determine Taiwan's future "a threat" to the peace and security of the Western Pacific and of "grave concern" to the United States; "to provide Taiwan with arms of a defensive character;" and "to maintain the capacity of the United States to resist any resort to force or other forms of coercion" jeopardizing the security, or social or economic system of Taiwan's people. The TRA provides a congressional role in determining security assistance "necessary to enable Taiwan to maintain a sufficient self-defense capability." President Reagan also offered "Six Assurances" to Taipei in 1982, partly to continue arms sales.

Policy makers have continued to face unresolved issues, while the political and strategic context of the policy has changed dramatically since the 1970s. Since the early 1990s, U.S. interests in the military balance as well as Taiwan's security and democracy have been challenged by the PRC's military buildup (particularly in missiles) and potential coercion, moves perceived by Beijing for Taiwan's *de jure* independence under the Democratic Progressive Party's (DPP's) president (2000-2008), and resistance in Taiwan by the Kuomintang (KMT) party to investing in self-defense. After the KMT's Ma Ying-jeou became President in May 2008, Taipei and Beijing reduced tension and resumed talks—beyond seeking detente. With President Obama since 2009, a rhetorical convergence emerged about "peaceful development" of cross-strait ties. However, disagreements remain about the PRC's goal of political talks for unification, Taiwan's status, Taiwan's self-defense, and U.S. arms sales and other cooperation with Taiwan. On September 23, 2014, 29 Members of the House sent a letter to Secretary of State John Kerry, calling for a new Taiwan Policy Review (after 20 years) to examine expanded engagement with Taiwan.

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U.S., Taiwan: Why a Military Conference Matters to China

Snapshots

Feb 22, 2018 | 21:31 GMT

3 mins read

(Stratfor)

Forecast Update

Stratfor's 2018 Annual Forecast stated that Taiwan had the potential to be a source of contention between Washington and Beijing as the United States works to bolster its allies in China's neighborhood. Recent events confirm that analysis, and suggest Washington's strategy is to continue pursuing this pressure point to contain Beijing.

China may be dead set on pressuring Taiwan, but the United States is making subtle adjustments to challenge the cross-strait status quo. And the latest U.S. move has Taiwan set to host a U.S.-Taiwan defense industry conference for the first time in May. Though the annual gathering has been held in the United States the past 16 years, both sides have agreed to take turns holding the event going forward. And in 2018, the event will be held in two parts, with the main conference expected to take place in the United States in October. The split nature of the event may soften the blow for China slightly, but holding any part of it on Taiwanese soil will still sting.

Moreover, the event could eventually provide an opportunity for the United States to needle China further by sending high-ranking officials to Taiwan. The Taiwan Travel Act has not yet been signed into law, but its enactment would allow the United States and Taiwan to exchange visits from senior officials. The annual defense conference is typically attended primarily by defense contractors and military

officials, but altering that would be an effective means for the United States to further challenge the "One China" narrative.

China views Taiwan as a wayward province, and vocally rejects any attempts to recognize it as a sovereign entity. But the United States has been laying the foundation for strategies to contain and challenge China, which it now labels its top strategic competitor. In late 2017, U.S. President Donald Trump signed the National Defense Authorization Act into law. The law calls for increased defense cooperation with Taiwan, including arms sales and a feasibility study of port of call exchanges. Beijing has voiced bitter opposition to the law, which it says places unnecessary strain on the relationship between China and the United States. But, in addition to the Taiwan Travel Act, Congress has already introduced multiple bills that would legitimize Taiwan's status in the international community in ways that Beijing opposes.

Each of these steps from the United States, once mature, will widen the chasm between Washington and Beijing. Though China has watched warily to see how far the United States will push, it has wasted no time ratcheting up pressure against Taiwan by poaching its diplomatic allies and increasing its military presence around the island. China may respond to the United States by pursuing less collaboration in military exchanges or dialogues, but such an avenue may be less effective than it has been in the past. And as Taiwan gets pushed further toward the center of competition between the United States and China, Beijing's hopes for a peaceful reunification with the island will slip further away.

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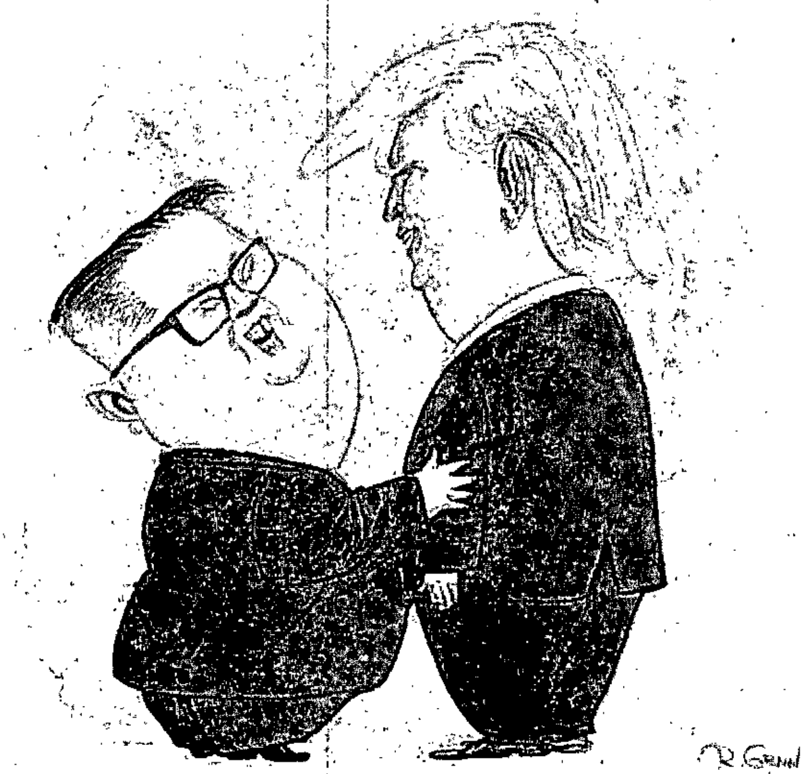
Kim Wins in Singapore

By NICHOLAS EBERSTADT | June 21, 2018 10:58 AM



(Roman Genn)

Like it or not, it was a triumph of statecraft.

The remarkable truth about the "North Korean nuclear crisis" is that the Democratic People's Republic of Korea — a tiny, isolated, and impoverished state — has been almost completely in charge of it since the global drama erupted almost three decades ago. The DPRK has determined both the tempo of events and the details of international diplomacy, right down to the conference agendas: what parties would meet, when and where the meetings would take place, and even what would be discussed. This is a drama

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with a purpose, for the outcome of this ongoing "crisis" has been the steady march of a most unlikely candidate into the ranks of the nuclear-weapons states.

Like it or not, this is a triumph of statecraft. To succeed in the effort that culminated last year — in the testing of a hydrogen bomb and an intercontinental ballistic missile capable of striking the U.S. mainland — North Korea had to thwart a world community overwhelmingly opposed to its nuclear intentions. That meant gaming the great powers, not to mention most of the rest of the international community, for decades on end.

The Kim-family regime and its notorious peculiarities are endlessly mocked in the outside world. Be that as it may: A remote, closed-off, and seemingly buffoonish dictatorship has demonstrated time and again that it understands more about global power politics than do its powerful and purportedly sophisticated adversaries.

This month's U.S.–North Korean summit in Singapore marks a truly historic milestone on the DPRK's road to establishing itself as a permanent nuclear power. Whether Washington recognizes it yet or not, the encounter was a victory for Pyongyang — and a big one. Indeed, it is hard to think of any greater diplomatic coup for the North Korean regime since 1950, when missions to Moscow by "Great Leader" Kim Il-sung (grandfather to the current "Dear Respected Leader") secured Stalin's permission for a surprise attack on South Korea.

With a single stroke in Singapore, Kim Jong-un apparently defanged President Donald Trump, North Korea's most formidable American opponent in the post–Cold War era; consolidated the recent advances in the DPRK's nuke and missile programs; and positioned North Korea to reap even greater gains from its high-tension, long-term game plan in the months and years ahead. The Singapore summit, in other words, looks to have been a signal step toward making the world safe for Kim Jong-un and his regime.

The quarter century and more of events that led us to today's thermonuclear North Korean state underscore a profound and general lack of understanding on the part of the many governments that have been attempting to thwart the DPRK's nuclear ambitions. There has been a global failure to understand the strategy that has informed North Korea's conduct. That pervasive and enduring intellectual failure, for its part, turns on a lack of understanding about the North Korean state's nature, underlying logic, and objectives.

True, the DPRK is a unique political construct and therefore unusually difficult for outsiders to understand. But taxing ourselves to comprehend this fundamentally unfamiliar political life form is an urgent necessity.

The DPRK was born as a Stalinist satellite state in the aftermath of World War II, but unlike the captive nations on the Soviet Union's western borders, it broke free of the Kremlin's orbit early on and gradually implemented a dramatically different sort of totalitarian despotism. This metamorphosis helps explain why the North Korean regime survived when the USSR and all of the other Soviet satellites collapsed.

It is not just that the DPRK diligently and exquisitely improved upon — one is tempted to say perfected — the domestic mechanisms of police-state control and terror that were its Stalinist patrimony, or that it managed to effect a historically unprecedented long-term militarization, setting its society and economy on something approaching a full war footing these past 50 years and more. The state also mutated into that most un-Marxian of political arrangements, an Asiatic dynasty replete with hereditary rule.

Along the way the DPRK jettisoned its vestiges of Communist ideology — removing not only Stalin but also Lenin and even Marx from their places of honor in both the official canon and the public statuary. Replacing the aspirational ideal of Communism was "our own style of socialism," devised by

the immortal thinkers "Great Leader" Kim Il-sung and "Dear Leader" Kim Jong-il (his son). The new ideology disdained Marxism-Leninism's universalism, focusing its message instead on the Korean people alone and beating out an incessant tribal war call for them.

North Korea's official doctrine of what we might call "racial socialism" holds that the Korean nationality (*minjok*) had been oppressed from time immemorial by the more powerful nations surrounding it — until a savior arose in the form of Kim Il-sung, who led his people into the shelter of the "independent socialist state" he fashioned in the North. The destiny of the Korean *Volk* will ultimately be fulfilled when *all* the Koreans of the peninsula are gathered together under that same independent socialist state — at which point a magnificent new historical era will commence, with Korea finally reunited and Koreans finally ready to stand up to all foreigners and take charge of history.

Absolute and unconditional reunification of Korea under the authority of the Kim regime, then, is imperative — and nonnegotiable. This is not some bargaining chip to be horse-traded away for better terms on some other items of interest to North Korean leadership. The call for unconditional reunification stands as a central and sacred mission for the North Korean state. The inconvenient existence of the government of the Republic of Korea stands very much in the way of Pyongyang's vision of a peninsula-wide racial utopia; thus the South Korean state must be erased from the face of the earth.

Unless one takes seriously the North's claim to unchallenged rule of all Koreans on the peninsula and its implacable determination to exterminate the other Korean state, one cannot make sense of Pyongyang's unashamedly revisionist foreign and defense policies — or its obsession with nukes and missiles.

Why is it so crucial to North Korean leadership to "mass-produce nuclear warheads and missiles and speed up their deployment," as Kim Jong-un announced his government was doing in his New Year's Day Address earlier this

year? Such a program would not be necessary for regime legitimation, or for international military extortion, or even to ensure the regime's survival: All of those objectives could surely be satisfied with a limited nuclear force. Why then threaten the U.S. homeland?

Quite simply, because Uncle Sam is the longstanding guarantor of South Korean security — and if Uncle Sam can be forced to blink in a crisis of Pyongyang's making, at a place and time of Pyongyang's choosing, the U.S.–ROK alliance will collapse, America's security presence in the Korean Peninsula will end, and North Korea will be closer to unconditional reunification than it has been at any point since the summer of 1950.

Just to be clear: North Korean absorption of the South would hardly be a foregone conclusion even in such a hypothetical scenario. The South is much more populous, vastly more productive, far more technologically advanced, and capable of becoming a nuclear power quickly. Yet North Korean leadership appears convinced that the South is hopelessly corrupt, pampered, and gutless, and that it would ultimately lack the will to resist a forced reunification.

Severing the U.S.–ROK security alliance is the sine qua non for the North's grand vision of reunification — and amassing a powerful nuke and missile force is the sine qua non for severing the U.S.–ROK security alliance. In earlier times, when the South was weaker and the North was stronger, other paths might have appeared feasible, including another full-frontal conventional military assault. But today, nukes and missiles look to be the only option.

If we understand this, we also understand how unrealistic any expectation of a voluntary North Korean denuclearization must be.

America's sorry record on North Korean nuclear proliferation stems in large part from its failure to see North Korea as it actually exists and its attempt to deal with an imaginary, much more tractable North Korea

instead. From Bush 41 through Obama, an unbroken string of U.S. administrations focused on resolving the issue through international negotiations. They missed the fact that North Korea regards international negotiations as war by other means. To make a long, sad saga short, American negotiators were consistently wrong-footed, fooled, and flummoxed by their North Korean counterparts, not only because the DPRK negotiators were almost invariably better prepared (having "war-gamed" these meetings in advance), but also because the North had no compunction about negotiating in bad faith.

North Korean leaders perfected an extraordinarily effective routine for breaking through Western nonproliferation strictures: First, push nuclear and missile programs forward as fast as possible, either furtively or through brazen open testing. Second, make aggressive and ominous noises when confronted, giving hints that the Korean Peninsula is on the verge of war. Third, suddenly change from bellicose to conciliatory, graciously agree to international conferences, use said conferences to consolidate and secure official recognition of the newest North Korean gains, and agree to a few points of interest to the foreigners with no intention of honoring them. Fourth, repeat.

Americans, to be sure, were not the only ones suckered by the illusory prospect of "getting to yes" with Pyongyang: The South Koreans, Japanese, and others took the bait too, some repeatedly. But traducing the U.S. is always most important, considering Washington's adversarial relationship with Pyongyang, its unrivaled international power, and its indispensable role in the security architecture of Northeast Asia and the world.

Donald Trump came to office intent on upending the perverse modus operandi under which his predecessors, Republicans and Democrats alike, had haplessly watched the North Korean threat grow bigger and more menacing. He replaced Obama's passive-aggressive lassitude with an active and assertive policy, one that accorded the North Korean threat a top ranking among U.S. security concerns and attempted to reduce the threat systematically. Through defensive

military measures, energized economic sanctions, alliance-strengthening and coalition-building, elevating the prominence of North Korean human-rights issues internationally, and more, Trump and his team fashioned an approach that promised to reduce the North Korean threat.

Officials at various executive agencies brought together something more closely resembling a coherent international strategy on North Korea than anything previously witnessed in the post–Cold War era. A measure of international cohesion against North Korea not previously observed began to come into force as well, with longstanding DPRK benefactors (such as China) and would-be benefactors (such as South Korea's new "Sunshine" government) adopting a tougher posture on Pyongyang.

While international-trade figures are by no means perfect, they suggest that Trump's "maximum pressure" campaign has sharply constricted the flows of commercial merchandise into North Korea and North Korea's revenues from commercial exports — and since the North Korean economy is exceptionally distorted and dependent upon outside resources, such sanctions stand a serious chance of eventually crippling it, including the state's defense industries. Pyongyang's leadership also inadvertently testified to the success of the sanctions campaign — or at least the promise of its success — by ratcheting up its hysterical war rhetoric as the Trump administration rolled out its policies.

Perhaps Richard Nixon's Vietnam War "madman theory" helps to explain Trump's initial success: As a new and rather different sort of political leader, Trump could credibly play the part of a madman. From his tweets about "fire and fury" to the "bloody nose" rumor (White House press corps speculation about preemptive U.S. strikes against the DPRK), new uncertainties about the U.S. commander in chief may have helped pull China and other reluctant partners into line.

Also, last month, President Trump announced that the U.S. was withdrawing from its multilateral nuclear deal with Iran. While this decision provoked outcry, exiting the deal was exactly the right move for a "maximum pressure" campaign on North Korea. As the Hudson Institute's Tod Lindberg noted, an agreement like this — generously front-loaded with benefits, a bit vague about the nonproliferation back end — is exactly what North Korea would demand if the U.S. maintained a similar deal with Iran. But Trump unburdened himself of this potential complication.

As he prepared to head to Singapore for a first-ever face-to-face meeting with Kim Jong-un, Trump looked well positioned to wrest genuine international concessions from a North Korean dictator — something that had arguably never been done before. He was certainly better positioned than any previous president to roll back North Korea's nuclear clock.

Given the hopes that President Trump's North Korea policy had generated in the roughly 18 months leading up to Singapore, the results were little short of shocking. There is no way to sugarcoat it: Kim Jong-un and the North Korean side ran the table. After one-on-one talks with their most dangerous American adversary in decades and high-level deliberations with the "hard-line" Trump team, the North walked away with a joint communiqué that read almost as if it had been drafted by the DPRK ministry of foreign affairs.

The dimensions of North Korea's victory in Singapore only seemed to grow in the following days, with new revelations and declarations by the two sides. What remains unclear at this writing is whether the American side fully comprehends the scale of its losses, and how Washington will eventually try to cope with the setbacks the meeting set in motion.

Kim Jong-un's first and most obvious victory was the legitimation the summit's pageantry accorded him and his regime. The Dear Respected Leader was treated as if he were the head of a legitimate state and indeed of a world power rather

than the boss of a state-run crime cartel that a U.N. Commission of Inquiry wants to charge with crimes against humanity. In addition to the intrinsic photo-op benefit of a face-to-face with an American president who had traveled halfway across the globe to meet him, the Dear Respected Leader bathed in praise from the leader of the free world: Kim Jong-un was "a talented man who loves his country very much," "a worthy negotiator," and a person with whom Trump had "developed a very special bond." Kim even garnered an invitation to the White House. These incalculably valuable gifts went entirely unreciprocated.

Second: Kim was handed a major victory in terms of what went *missing* from the summit agenda. For the Kim regime's security infractions are by no means limited to its domestic nuke and missile projects.

As Professor Bruce Bechtol Jr. details in an important forthcoming book, North Korea is a WMD merchant for Iran, Syria, Hezbollah, Hamas, and other elements in the Middle East, supporting and in turn being supported by an unholy alliance of terror agents abroad. Not unrelated, North Korea maintains immense stockpiles of chemical weapons, as Kim Jong-un's assassination of his half-brother in a Malaysian airport with nerve agents was certainly intended to remind us. North Korea is also actively involved in cyber warfare and cyber crime, as the Sony hacking and the cyber-robbing of numerous overseas banks attest. DPRK security services routinely abduct foreign nationals — from Japan, South Korea, Europe, and maybe even America — as has been documented by HRNK, the Committee for Human Rights in North Korea. And then there is the nightmare of human rights under the regime — a catastrophe unparalleled in the modern world — and its commitment to eradicating the Republic of Korea, a U.N. member state.

In getting a pass on all these matters in the official record of its deliberations with Washington, North Korea scored a huge plus.

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Third: Regarding the key issues that *were* mentioned in the joint statement, the U.S. ended up adopting North Korean code language.

Until (let's say) yesterday, the U.S. objective in the North Korean nuclear crisis was to induce the DPRK to dismantle its nuclear armaments and the industrial infrastructure for them. Likewise with long-range missiles. Thus the long-standing U.S. formulation of "CVID": "complete verifiable irreversible denuclearization." But because the nuclear quest is central to DPRK strategy and security, the real, existing North Korean state cannot be expected to acquiesce in CVID — ever. Thus its own alternative formulation, with which America concurred in Singapore: "complete denuclearization of the Korean Peninsula."

In this sly formulation, South Korea would *also* have to "denuclearize" — even though it possesses no nukes and allows none on its soil. How? By cutting its military ties to its nuclear-armed ally, the U.S. And if one probes the meaning of this formulation further with North Korean interlocutors, one finds that even in this unlikely scenario, the DPRK would treat its "denuclearization" as a question of arms control — as in, if America agrees to drawing down to just 40 nukes, Pyongyang could think about doing the same. The language of "denuclearization of the Korean Peninsula" ensured that no tangible progress on CVID was promised in the joint statement.

Likewise the communiqué's curious North Korean–style language about agreeing to build a "peace regime" on the Korean Peninsula. What is the difference between a "peace regime" and plain old "peace," or, say, a peace treaty among all concerned parties? From the North Korean standpoint, a "peace regime" will not be in place until U.S. troops and defense guarantees are gone — and a peace treaty between North and South may not be part of a "peace regime," either, because that would require the DPRK to recognize the right of the ROK to exist, a proposition it has always rejected.

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Fourth: The North delivered absolutely nothing on the American wish list at the summit and offered only the vaguest of indications about any deliverables in the future. No accounting of the current nuke and missile inventory. No accounting of the defense infrastructure currently mass-producing nukes and missiles. No accounting of WMD sales and services in the Middle East, or cyber-crime activities, or counterfeiting, or drug sales. Not even a small goodwill gesture, such as the release of Japanese abductees or an admission that North Korean agents did indeed kidnap David Sneddon, a young American last seen in China, as many who have followed the case believe.

Nor did Team Trump's much-vaunted timetable for handing over nukes and dismantling WMD facilities emerge. Quite the contrary: As Bruce Klingner of the Heritage Foundation and others have pointed out, the joint language commits North Korea to even *less* than any of its previous (flagrantly violated) nuclear agreements did: less than its agreements with South Korea in 1991 and 1992; less than its Agreed Framework in 1994; less even than the miserable Joint Statement from the so-called Six-Party Talks in 2005.

With the Singapore communiqué in hand, the Dear Respected could return home and rightly claim that the Americans had not laid a glove on him. The diplomatic debacle for America, on the other hand, only seemed to grow as new details surfaced and new pronouncements about the meeting were issued.

While still in Singapore, President Trump publicly acknowledged that human rights had barely come up — even while announcing that the U.S. had decided, apparently on the spot and without prior consultation, to halt the joint U.S.–ROK military-readiness exercises that prepare the alliance against a North Korean assault. (He called these exercises "war games" and said they were "provocative" — just as North Korean propaganda has long insisted.) He also mused about getting all U.S. troops out of Korea at some point in the future. Subsequently, in a taped television interview, Trump declared that he "trusted" Kim Jong-un — and by the time he had landed back in Washington, he was

tweeting that "there is no longer a nuclear threat from North Korea" and that Americans could "sleep well tonight."

In fairness, we should acknowledge that the Singapore summit may not be quite as awful for the American side as events to date suggest. It is possible, for example, that the U.S. secured meaningful deliverables that have not been publicly announced. But as my American Enterprise Institute colleague Dan Blumenthal has emphasized, the North Korean media would have to ready Kim's subjects and elite for any concession or change in policy worthy of the name — and there is, as yet, no evidence of this. More likely, alas, is the possibility that Kim and Co. treated the Americans in private to a number of grand and utterly unenforceable promises — North Korean diplomacy specializes in this particular device. Conversely, we do not yet know what the U.S. may have given the North out of public view: The joint statement talks of U.S. "security guarantees" for Pyongyang, for example, but apparently we will learn what this means only in the fullness of time.

At any rate, the public record of the summit looks like a World Series of unforced errors for America, needlessly boxing us into a corner where we should not want to be. In addition to undermining our alliance with South Korea, the summit weakened the rationale for aggressive economic sanctions against the DPRK. After all, if there is no more North Korean nuclear threat, as Trump claims, why should there be "maximum pressure"? Washington asserts that sanctions against North Korea will still be enforced until DPRK denuclearization is completed. But as a practical matter America will find it increasingly difficult to rein in the governments that want to break ranks — most important, China, Russia, and our ally South Korea.

Within hours of the Singapore communiqué, Beijing was already calling for an easing of those sanctions, and reports allege that Beijing has already begun to ease them unilaterally. The more porous the sanctions, the faster North Korea can credibly threaten San Francisco with incineration.

The mystifying question of the Singapore summit is this: How could the American team make so many major-league miscalculations at a single sitting? Why would the president take the lead in subverting his own North Korea policy — the first such policy in a generation to make an inroad against the North Korean threat? A comprehensive assessment must await future historians, but we already have a few clues.

The U.S. position at the summit, to begin, betrayed poor preparation for the negotiations and an almost inexplicable unfamiliarity with the negotiating partner. In the lead-up, for example, the U.S. counted as good-faith gestures North Korea's decommissioning of a nuke test site at Mt. Mantap that was no longer usable and a special promise to cease nuke and missile tests even though Kim had already declared at the start of the year that the DPRK was moving from testing to mass production and that further testing was not needed for now.

America's naïveté at the summit was perhaps most vividly and embarrassingly encapsulated by a bizarre movie-trailer-style video from something called "Destiny Pictures" that the U.S. team obliged the Dear Respected Leader to watch: a short film clip fantasizing about the real-estate and technology bonanza a wealthy future North Korea could enjoy if only Pyongyang's leadership made the decision to give up the nukes and become a peaceful state.

The provenance of this video is unclear — the U.S. National Security Council has formally taken responsibility for it, though some viewers say it practically screams "Made in South Korea" — but regardless, the product itself constituted a painfully poor job of salesmanship. No one who had heard of *songbun*, the control system that assigns roughly a third of North Korea's population to a bleak fate in the "hostile classes," could ever imagine that Kim Jong-un wants *all* his subjects to be rich. Nor were the producers apparently aware that Kim already has a plan in place for stimulating both national prosperity *and* military might: It is called *byungjin*, or "simultaneous pursuit."

Another factor, potentially significant but as yet shrouded in secrecy, is the South Korean role in convincing the Trump administration to move ahead with the summit. Since the start of the year, when Kim Jong-un kicked off his international "charm offensive," the top leaders of Seoul's "Sunshine" government have been granted repeated audiences with the Dear Respected. So far as we know, Washington has not yet been given a transcript of any of those discussions. Instead, the Blue House has taken on the role of intermediary and messenger, reporting to the White House what North Korea is supposed to have said. South Korea's odd "as told to" diplomacy, which inter alia provided deniability to Pyongyang for any of Seoul's representations to Washington, seems to have had a powerful influence on U.S. decision-making.

We know, for example, that President Trump made an on-the-spot determination to meet with Kim Jong-un after being briefed in March by the South Korean national-security adviser about Kim's desire for a U.S.–DPRK summit. By the same token, after President Trump's decision in late May to call off that summit in response to an especially vicious statement from the North Korean foreign ministry, South Korean president Moon Jae-in immediately held an emergency summit with Kim Jong-un, thereafter coaxing Trump to put the summit back on.

At the end of the day, the incontrovertible fact is that President Trump showed himself to be hungry for this summit, no matter what. Whether President Moon's flattering comments about the Nobel Peace Prize had any impact on that appetite cannot yet be determined. What is clear is that Team Trump, which had consistently avoided the sorts of mistakes previous administrations had made, stumbled into a series of North Korean negotiating traps. To judge by the evidence at hand, it would appear that the president strongly preferred the prospect of a bad deal with North Korea to no deal at all.

hat comes next? Both sides say there will be more U.S.–DPRK conferencing and negotiating; this does indeed look likely. The U.S. says it will firmly maintain

W "maximum pressure" until North Korea dismantles its nukes; while that is possible, it is not entirely likely.

The U.S. also says it expects the North to begin delivering on meaningful denuclearization by the end of the year. This would have been an unrealistic notion before the Singapore summit, but in the wake of the summit it looks like dreaming. Only if the North Korean regime chooses to chart an entirely new — and from the standpoint of regime stability, extremely dangerous — course could there be hope for what the international community would call a happy conclusion to the North Korean crisis. Thus far there is absolutely no evidence that the Kim regime is even toying with the idea of such a course.

Some prominent voices have averred that North Korean denuclearization would necessarily be a complex and protracted affair. One highly esteemed expert, Siegfried Hecker, has even ventured that the process could take up to a decade and a half to complete. Hecker must not have been involved in the denuclearization of Ukraine at the end of the Cold War. For a time, Ukraine possessed the world's third-largest nuclear arsenal: roughly 1,800 warheads. In December 1994, Ukraine joined the Nuclear Nonproliferation Treaty. In June 1996, the last nuclear warhead in the Ukrainian arsenal was removed from Ukrainian soil. If Ukraine could denuclearize in a year and a half, the DPRK — with an inventory orders of magnitude smaller — could presumably do so in months. But only if it wanted to. What is lacking for North Korean denuclearization is not technical expertise; it is a desire to disarm.

Having bested the Americans in Singapore, North Korean leaders must be looking forward to repeats and three-peats in upcoming talks. And Pyongyang has already laid down a number of markers for all who are willing to see them.

It is no accident, for example, that the Dear Respected arrived in Singapore in an Air China jet. Beijing is once again very publicly in North Korea's corner: It will be advocating once more a "freeze for freeze" (a cessation of already-ended

DPRK nuke and missile tests in exchange for a halt in joint U.S.–ROK training) and a process of "phased denuclearization," a term that can best be translated for the non-specialist as "no North Korean denuclearization at all." No love is lost between Chinese and North Korean leadership, but they are united in the overarching strategic objective of overturning *Pax Americana* in Asia.

By the same token, barely a week before the Singapore summit, North Korea's KCNA news service reported that Syrian president Bashar al-Assad was looking forward to arranging a state visit to Pyongyang to parlay with Kim Jong-un. The subtext here is not hard to see: North Korea has a lot of clients who are willing to pay good money for its weapons of mass destruction, and if the Americans want to end these sales, Washington is going to have to pay up instead.

The money matters to Pyongyang. Until the international sanctions are lifted, the Kim regime must draw down its financial and strategic reserves to fund its nuke and missile programs. Nukes and ICBMs are expensive — not least for a technologically backward and financially bankrupt nation with a tiny economy. So long as the sanctions are working, the DPRK is in a race against time; if the sanctions can be broken, North Korea will have the breathing space to get its nuclear game up to the next level, and on a timetable of its own choosing.

As for the United States and her allies, the setback in Singapore was serious but by no means insurmountable. The U.S. still has vast resources — economic, diplomatic, military — that it can deploy. It can progressively reduce the scale and scope of the North Korean threat if it falls back to a Plan B that resembles its Plan A up until about a month ago.

There should be no doubt that Pyongyang will be more confident and assertive after Singapore. The Kim regime is betting that it has already taken the worst the Trump administration has to give. For our own national security, and for that of our allies, we must hope they are wrong.

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How the U.S. and China Differ on North Korea

They are at odds over the nature of the threat posed by Pyongyang.

North Korean leader Kim Jong Un meets scientists and technicians

KCNA via Reuters

KRISHNADEV CALAMUR

NOV 28, 2017 | GLOBAL

Last week, President Trump named North Korea a state sponsor of terrorism, tagging the communist country with the label almost a decade after the Bush administration removed it. "In addition to threatening the world by nuclear devastation, North Korea has repeatedly supported acts of international terrorism, including assassinations on foreign soil," Trump said last Monday, adding that the "North Korean regime must be lawful. It must end its unlawful nuclear and ballistic missile development, and cease all support for international terrorism, which it is not doing." The next day, the U.S. Treasury Department slapped sanctions on

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individuals and entities with links to North Korean financial institutions, including three Chinese companies. North Korea responded by calling the U.S. designation a "serious provocation and violent infringement."

For Washington, the road to a diplomatic solution with North Korea goes through Beijing. But despite public statements to the contrary, the United States and China are quite divided on some key questions, including why North Korea pursues nuclear weapons in the first place, and on the reasons why previous agreements to halt its illicit activities failed. Unless they can bridge these gaps, any lasting resolution of the North Korean crisis is unlikely.

The Trump administration has said that its goal is to isolate North Korea, in the hope that pressure through sanctions will compel it to renounce its nuclear and ballistic-missile programs and seek dialogue with the United States. But China, North Korea's largest trading partner and chief political benefactor, dismisses that idea. Beijing believes that for Washington to convince Kim Jong Un to come to the negotiating table, it must assure him that regime change is off the table. On several occasions, U.S. Secretary of State Rex Tillerson has said precisely that, but contradictory messaging from the White House has sent conflicting signals to North Korea—and China—about America's intentions.

In a recent meeting with a group of U.S. reporters in Beijing, Tong Zhao, a fellow at the Carnegie-Tsinghua Center for Global Policy said that, if backed into a corner, the North Korean regime isn't going to back down. "It is more likely to enhance its military threats because for North Korea this is basically a game of risk-taking between Pyongyang and Washington," he said.

North Korea has a long history of provocation in the face of what it regards as threats from the United States and South Korea. It has warned of a "merciless strike" in retaliation against their joint military exercises, and said it would accelerate its nuclear-weapons program in response to the deployment in South Korea of the Terminal High Altitude Thermal Defense System, a U.S. anti-missile defense network. It has also warned that it would strike the U.S. territory of Guam after Trump vowed to bring "fire and fury" against North Korea if it threatened

America or its allies. But within these threats, Chinese analysts said, lies a fundamental disagreement between the United States and China over the nature of the threat posed by North Korea.

Chinese experts believe North Korea's leaders pursue nuclear weapons because they feel genuinely threatened by the United States and South Korea. In a Brookings Institution strategy paper published in May 2017, Fu Ying, a retired diplomat who represented China in multilateral talks on North Korea's nuclear weapons, wrote that in the early 1990s, Pyongyang felt especially vulnerable following the collapse of the Soviet Union, its main diplomatic and financial benefactor during the Cold War. Around the same time, China opened diplomatic relations with South Korea, the North's nemesis, while the United States and the South continued their military exercises, which the North viewed as a provocation. Feeling isolated, North Korea began its pursuit of nuclear weapons in earnest.

The view from Washington is quite different. Government officials and experts alike believe North Korea's pursuit of nuclear weapons has aggressive and offensive objectives. Pyongyang, they believe, will use its nuclear weapons to push U.S. forces out of South Korea and then force reunification of the Korean Peninsula on its terms. Trump administration officials said that North Korea must first commit to giving up its existing nuclear weapons (experts estimate the country has enough fissile material to build 20 such weapons). That position is a nonstarter in Pyongyang, and Beijing is sympathetic to its view.

"For the Chinese, we feel we can tolerate a nuclear-armed North Korea in the foreseeable future while we work out the long-term disarmament strategy," Zhao said. "But for the Americans, they are less likely to even accept a nuclear-armed North Korea for the near-term future."

The U.S. position can be better understood through the lens of a pair of earlier failed agreements with North Korea—failures caused, in Washington's view, by Pyongyang. The United States pulled out of 1994's Agreed Framework, under which then-leader Kim Jong Il agreed to freeze his country's nuclear program in exchange for certain concessions, because it believed the North had secretly

restarted a uranium-enrichment program. The 2012 Leap Day deal, under which the North agreed to suspend work on its uranium-enrichment program in exchange for U.S. food aid, collapsed because the North launched a satellite into space—a violation of the agreement, the Obama administration said. Both agreements hinted at what could be achieved through diplomacy. Alternately: They also served as cautionary tales of the perils of negotiating with an untrustworthy partner.

China interpreted these failures differently. As Chinese experts explained, Beijing contended that Pyongyang's secret uranium-enrichment program did not violate the Agreed Framework because that deal prohibited only plutonium enrichment. Additionally, opposition to the agreement in the U.S. Congress sent mixed signals to Pyongyang about U.S. intentions, they said. The experts argued that this forced it to develop its clandestine uranium program as a hedge in the event the United States reneged on its commitment to the deal.

As for the Leap Day agreement: China believed there was never an agreement between the United States and North Korea to begin with, because they disagreed over whether a satellite launch constituted a ballistic-missile test. (Washington equated satellite launches with ballistic-missile testing; Pyongyang did not.) Consequently, the Leap Day agreement died when Pyongyang launched a satellite soon after it was signed.

"The Chinese interpretation of North Korea's behavior was [that] they, by and large, are still trustworthy partners," Zhao said. "They wanted to implement their commitment—they're not evil cheaters who want to take advantage of every agreement. So that really affects how China drafts its North Korea policy."

So what does China want? Its plan to resolve the crisis is the so-called "freeze-for-freeze" proposal, in which North Korea would halt its missile and nuclear programs in exchange for the United States and South Korea suspending their joint military exercises—a nonstarter for Washington, which prefers to increase pressure on North Korea while holding open the offer of dialogue.

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Unless China adopts America's approach, at least in part (or vice versa), the crisis is unlikely to diminish. "Even though at the surface level they appear cooperative, deep down their approaches of dealing with North Korea are fundamentally different," Zhao said. Ultimately, Zhao said, the nature of the disagreements between Washington and Beijing ensures that the crisis of North Korea's nuclear and missile programs will remain unresolved for some time to come.

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COUNCIL *on* FOREIGN RELATIONS

The China–North Korea Relationship

China is North Korea's biggest trade partner and arguably has the most leverage on Kim Jong-un's regime. But while Beijing appears willing to condemn its neighbor's nuclear developments, analysts say its cautious policies remain focused on stability.

Backgrounder *by* Eleanor Albert

Last updated February 8, 2018

Chinese Communist Party official Liu Yunshan with North Korean leader Kim Jong-un in Pyongyang. Kyodo via Reuters

Introduction

China is North Korea's most important trading partner and main source of food and energy. It has helped sustain Kim Jong-un's regime, and has historically opposed harsh international sanctions on North Korea in the hope of avoiding regime collapse and a refugee influx across their 870-mile border. Pyongyang's nuclear tests and ongoing missile launches have complicated its relationship with Beijing, which has continued to advocate for the resumption of the Six Party Talks, the multilateral framework aimed at

denuclearizing North Korea. A purge of top North Korean officials since its young leader came to power and the assassination of Kim Jong-nam, Kim Jong-un's exiled half-brother, in Malaysia also spurred concern from China about the stability and direction of North Korean leadership. Yet China's policies have done little to deter its neighbor's nuclear ambitions.

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China's support for North Korea dates back to the Korean War (1950–1953), when its troops flooded the Korean Peninsula to aid its northern ally. Since the war, China has lent political and economic backing to North Korea's leaders: Kim Il-sung (estimated 1948–1994), Kim Jong-il (roughly 1994–2011), and Kim Jong-un (2011–). But strains in the relationship began to surface when Pyongyang tested a nuclear weapon in October 2006 and Beijing supported UN Security Council Resolution 1718, which imposed sanctions on Pyongyang. With this resolution and subsequent ones, Beijing signaled a shift in tone from diplomacy to punishment. After North Korea's latest missile launch in November 2017, China expressed "grave concern and opposition," calling on North Korea to cease actions that have increased tensions on the Korean peninsula.

> "The two enjoy at best a cold relationship that is likely to worsen."
>
> – Jeffrey Bader, *Brookings Institution*

China's punitive steps have been somewhat restrained though. For example, China backed UN Resolution 2375 in September 2017 after some of the measures in a draft version were dropped, including an oil embargo and the authorization to use force when ships do not comply with mandated inspections. Western officials and experts doubt how committed China is to implementing even limited trade restrictions.

Still, Beijing continues to have sizeable economic ties with Pyongyang. Bilateral trade increased tenfold between 2000 and 2015, peaking in 2014 at $6.86 billion, according to figures from the Seoul-based Korea Trade-Investment Promotion Agency. With the advent of tougher sanctions, trade growth has dampened, but Pyongyang is still dependent on Beijing for economic activity.

Yet Beijing seems more inclined to uphold some of the international sanctions against Pyongyang and increasingly poised to take some limited measures to squeeze its neighbor economically. For example, China's commerce ministry temporarily suspended coal imports from North Korea in February 2017. State-owned oil giant China National Petroleum Corporation suspended fuel sales to North Korea in June 2017, citing concerns that North Korea would fail to pay the company. In September 2017, media reports cited efforts by Chinese banks, including China Construction Bank, Bank of China, and the Agricultural Bank of China, to restrict the financial activities of North Korean individuals and businesses.

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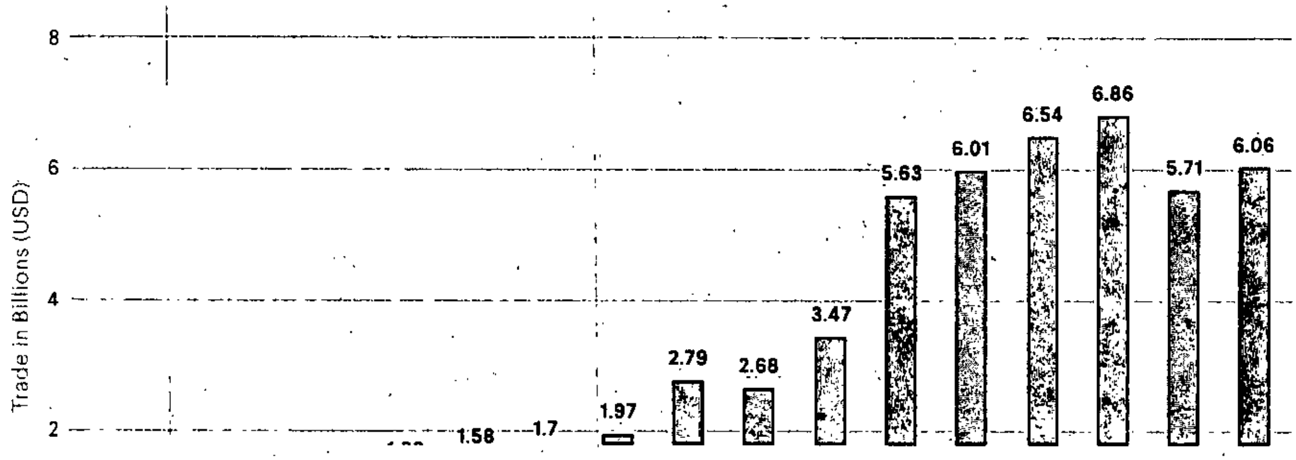
Aid and Trade for Pyongyang

16.7%

The drop in Chinese imports from North Korea in first three quarters of 2017

Source: China General Administration of Customs

In recent years, despite Beijing's displeasure at Kim Jong-un's unwavering nuclear ambition, connectivity between China and North Korea has grown. China provides North Korea with most of its food and energy supplies and accounts for more than 90 percent of North Korea's total trade volume. In the first three quarters of 2017, Chinese imports from North Korea actually fell by 16.7 percent, though exports were up by 20.9 percent. Despite announced trade restrictions in textiles, seafood, and oil products, there are reports of North Korean businesses still in operation in China.



Bilateral trade between China and North Korea has steadily increased. Korea Trade-Investment Promotion Agency (KOTRA).

In September 2015, the two countries opened a bulk-cargo and container shipping route to boost North Korea's export of coal to China and China established a high-speed rail route between the Chinese border city of Dandong and Shenyang, the provincial capital of China's northeastern Liaoning province. In October 2015, the Guomenwan border trade zone opened in Dandong with the intention of boosting bilateral economic linkages, much like the Rason economic zone and the Sinujiu special administrative zone established in North Korea in the early 1990s and 2002, respectively. Dandong is a hub for trade, investment, and tourism for the two neighbors—exchanges with North Korea made up 40 percent of the city's total trade in 2015 and 70 percent of trade in and out of North Korea was conducted via Dandong and Sinujiu in 2016. However, a new $350 million bridge over the Yalu River to connect the two cities, intended to open in 2014, remains incomplete across the North Korean border, a symbol of cooling relations between Beijing and Pyongyang. Still, North Korea's dependence on China

continues to grow. Moreover, established informal trade along the China-North Korea border in items such as fuel, seafood, silkworms, and cell phones signals that despite stricter sanctions, smugglers continue to operate.

Beijing also provides aid [PDF] directly to Pyongyang, primarily in food and energy assistance. China, Japan, South Korea, and the United States have provided more than 75 percent of food aid to North Korea since 1995, but donations from all countries except for China have shrunk significantly since the collapse of the Six Party Talks in 2009. North Korea, whose famine in the 1990s killed between eight hundred thousand and 2.4 million people, has repeatedly faced extensive droughts and severe flooding, which seriously damage harvests, threatening the food supply. UN agencies estimate that up to 70 percent of the population, or eighteen million people, is undernourished and food insecure. There is also concern about the distribution of aid in North Korea, particularly since China has no system [PDF] to monitor shipments.

China's Priorities

China has regarded stability on the Korean peninsula as its primary interest. Its support for North Korea ensures a buffer between China and the democratic South, which is home to around twenty-nine thousand U.S. troops and marines. "While the Chinese

certainly would prefer that North Korea not have nuclear weapons, their greatest fear is regime collapse," writes Jennifer Lind, a professor at Dartmouth University.

The specter of hundreds of thousands of North Korean refugees flooding into China has been a worry for Beijing. "Instability generated on the peninsula could cascade into China, making China's challenge of providing for its own people that much more difficult," says Mike Mullen, former chairman of the U.S. Joint Chiefs of Staff. The refugee issue is already a problem for China: Beijing's promise to repatriate North Koreans escaping across the border has consistently triggered condemnation from human rights groups. Beijing began constructing a barbed-wire fence more than a decade ago to prevent migrants from crossing, and a report in December 2017 indicated China had plans to construct refugee camps along its border as a contingency for a peninsular crisis. The majority of North Korean refugees first make their way to China before moving to other parts of Asia, including South Korea. However, tightened border controls under Kim Jong-un have decreased the outflow of refugees.

> "
> [For Beijing,] stability on the Korean Peninsula has always been prioritized over denuclearization.
> "

— Ely Ratner, *Council on Foreign Relations*

Though Beijing favors a stable relationship with Pyongyang, it has also bolstered its ties with Seoul. China's Xi Jinping has met with South Korean President Moon Jae-in and his predecessor, Park Geun-hye, on several occasions, while he has yet to visit or receive the North's Kim. China was South Korea's top trading partner in 2017 and the destination for a quarter of the South's exports. Meanwhile, South Korea ranked fourth among

China's trade partners. In recent years however, China has taken retaliatory measures against South Korean businesses to oppose the deployment of a U.S. missile defense system in South Korea's eastern province of North Gyeongsang.

Experts say China has also been ambivalent about its commitment to defend North Korea in case of military conflict. The 1961 Sino-North Korean Treaty of Friendship, Cooperation, and Mutual Assistance, up for renewal in 2021, says China is obliged to intervene against unprovoked aggression. But Bonnie Glaser of the Center for Strategic and International Studies says the Chinese government has tried to persuade North Korean leaders to revoke the clause that would force Beijing to come to Pyongyang's defense. The Brookings Institution's Jeffrey Bader describes the alliance between Beijing and Pyongyang as "a thing of the past," saying that "the two enjoy at best a cold relationship that is likely to worsen."

Beijing has urged world powers not to push Pyongyang too hard, for fear of precipitating the leadership's collapse and triggering dangerous military action. It has also intimated that if Pyongyang initiates conflict, it would not abide by its treaty obligation and instead stay neutral. Some experts, such as Oriana Skylar Mastro, have suggested that in the event of conflict, Chinese forces may not be involved in coming to North Korea's defense, but rather would seek to play a significant role in shaping a "post-Kim peninsula to its liking."

Washington's Role

The United States has pushed North Korea to irreversibly give up its nuclear weapons program in return for aid, diplomatic benefits, and normalization of relations. But experts say Washington and Beijing, while sharing the goal of denuclearizing North Korea, have different views on how to reach it. The United States values using pressure to force North Korea to negotiate on its nuclear weapons program, while China advocates for the resumption of multilateral talks and what it has called a "freeze for

freeze," a freeze in military exercises by the United States and its allies for a freeze in North Korea's nuclear and missile testing. Ultimately, for Beijing, "stability on the Korean Peninsula has always been prioritized over denuclearization," says CFR's Ely Ratner.

Washington has also tried to pressure Beijing to lean more heavily on Pyongyang. U.S. presidential executive orders [PDF] and congressional moves impose sanctions on countries, firms, or individuals contributing to North Korea's ability to finance nuclear and missile development. Some measures target North Korean funds in Chinese banks, while others focus on its mineral and metal export industries, which make up an important part of trade with China. Washington deployed a missile defense system known as the Terminal High Altitude Area Defense, or THAAD, in 2017 to boost regional security, though Beijing strongly condemned the move and sees it as a threat to Chinese national security.

> "If China is not going to solve North Korea, we will."
>
> — Donald J. Trump, *President of the United States*

The administration of President Donald J. Trump has shaken up U.S. policy toward North Korea. Officials have stated that "all options are on the table," alluding to the possibility of preemptive military strikes to thwart Pyongyang's nuclear tests and development. Trump has also warned that Washington will be prepared to take unilateral action against Pyongyang if Beijing remains unwilling to exert more pressure on its neighbor. "If China is not going to solve North Korea, we will," Trump said in an April 2017 interview with the *Financial Times*. Going even further, Trump told the UN

General Assembly in September 2017 that the United States would "have no choice but to totally destroy North Korea," if it was forced to defend itself or its allies. In January 2018, Trump softened his rhetoric and signaled a willingness to open more communication with leaders in Pyongyang, yet he continues to show signs of waning patience with diplomacy. Meanwhile, the U.S. military has stepped up joint exercises with Japan and South Korea and has periodically dispatched U.S. carrier strike groups near North Korea as a show of force.

Still, the United States appears more interested in leveraging China's economic influence over North Korea. Some experts, including David S. Cohen and Anthony Ruggiero, argue that Washington should impose more secondary sanctions that will penalize Chinese banks that help finance North Korean front companies. The U.S. Treasury has done just that, imposing some secondary sanctions on both Chinese and Russian entities. Meanwhile, other analysts worry that such economic pressures and further alienation of Pyongyang could embolden the Kim regime to resort to rash military action. Others question the effectiveness of sanctions in getting China to bring North Korea to the negotiating table. North Korea has vowed that the country's nuclear weapons program will never be up for negotiation.

Looking Forward

"North Korea is in a category all its own," writes the Brookings Institution's Jonathan D. Pollack. "The North Korean leadership has thus convinced itself (if not others) that its existence as an autonomous state derives directly from its possession of nuclear weapons." Though China may be unhappy about North Korea's nuclear brinkmanship, analysts say it seeks to avoid moves that could cause a sudden regime collapse. In a crisis, however, some say it would act swiftly to maximize its influence and protect its national interests.

Even as China signals that it will toughen its stance toward North Korea—though stopping short of challenging its survivability—there is mounting skepticism that China alone can resolve the North Korea problem. Chinese officials have emphasized that they do not "hold the key to the issue." Some analysts say that China's tightening of economic ties are unlikely to deter Kim's nuclear ambitions, while others say the North Korean leader no longer cares what China thinks of its actions.

Whether Chinese pressure can sway Pyongyang to alter its behavior remains to be seen, especially in a climate of mounting distrust in Northeast Asia, but North Korea's nuclear program is becoming increasingly problematic for China's desire to maintain regional stability.

Resources

The New York Times profiles a woman who built a commercial empire on trade between China and North Korea.

Riccardo Alcaro and Ettore Greco analyze the North Korea challenge in a November 2017 Global Governance Working Paper.

Evan Osnos explores China's reluctance to pressure North Korea in a September 2017 New Yorker article.

CFR experts Ely Ratner, Sheila A. Smith, and Scott A. Snyder discuss U.S. options on North Korea in this August 2017 conference call.

China expert Minxin Pei weighs in on China's policy decisions vis-à-vis North Korea in the Atlantic.

This 2016 CFR Independent Task Force report, A Sharper Choice on North Korea, argues that China's policy toward its neighbor will critically affect the fate of Asia.

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